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den Butter, F.A.G.; de Groot, H.L.F.

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Managing Transaction Costs

in Hybrid Forms of Organisations

Frank A.G. den Butter and Henri L.F. de Groot (eds.)

September 2014, 'Transactieland.nl' Foundation, The Hague

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Transactieland.nl
Postbus 95315
2509 CH Den Haag
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Table of contents

1	Introduction	4
2	Goodwill and transaction costs	10
3	Licensing and transaction costs	30
4	TCE and foreign entry mode of service firms: a case study in the international relocation sector	42
5	Samenvatting in het Nederlands	60

1

Introduction

Frank A.G. den Butter and Henri L.F. de Groot

In the organization of production processes, a distinction can be made between production through the market and through the hierarchy. Transaction costs are decisive for the choice between these two forms of organization. When the transaction costs through the market are higher than through the hierarchy, it is best to organize production within the firm. The reverse is true for the choice of organization through the hierarchy. This philosophy is based on the pioneering work on firm behavior of Ronald Coase (Coase, 1937), Nobel laureate in economics in 1991, and deceased in 2013 at the age of 102. In addition, Ronald Coase can also be considered as one of the founding fathers of the New Institutional Economics.

However, the choice between market and hierarchy is not the only strategic decision the management can make in the organization of its production process. Many intermediate forms are conceivable, so-called hybrid forms of organization. These include cooperative partnerships, alliances, licensing and franchising. As part of our honors course 'The economics of globalization: A transaction costs perspective' taught at VU University Amsterdam, some very good papers on this subject of hybrid organizations were written and presented by the students in the spring of 2013. This volume contains a selection of three of these papers which were presented in a workshop in The Hague early this year. During the workshop a number of interested parties from academia, government and the private sector were exchanging views about these organizational innovations which aim at reducing transaction costs in production service industries.

The paper by **Jeroen de Nie** titled "The relation between licensing and transaction costs" looks at the relationship between transaction costs and licensing. Licensing, where standards, ideas or rules developed by one company are used by another company, can be seen as a hybrid form

of organization between market and hierarchy. The paper describes how various aspects of the economic theory of transaction costs, such as "asset specificity" and uncertainty about institutions and about technological progress, may affect the strategic choice to use licensing in the organization of production or provision of services. The specific way in which the contracts of the licensing are designed and the extent to which they are enforced, play an important role in this hybrid form of organization.

The paper by **Erik Blokland** titled "Goodwill and transaction costs" is about how goodwill can be related to transaction cost economics. This relationship is twofold. Goodwill mainly plays a role when a company is offered for sale, or in the valuation of the company in the event of a merger or acquisition. In that case, the goodwill is part of the transaction costs when a company is sold or in the event of a merger or acquisition. Secondly - and this seems even more relevant from the perspective of transaction cost economics - goodwill can be seen as an asset on the balance sheet of the company, which reflects the valuation of the skill of organizing a company's production and sales at low transaction costs.

In that sense, goodwill reflects the investments in all sorts of hidden assets ("intangible assets"), which contribute to give the company a competitive advantage in efficiently achieving revenues and making profits. More specifically, the paper looks at two practical aspects, viz. (i) the valuation of goodwill among the four largest Dutch banks, and (ii) the valuation of the brand name in multinational companies with a strong brand. Such a brand name and the associated reputation is a good example of "invisible capital" that may bring about a reduction in transaction costs. Goodwill and appreciation of the brand name seem closely related, but prove not to be identical.

The paper by **Remo Corstjens** titled "TCE and foreign entry mode of service firms: a case study in the international relocation industry" describes how transaction costs play a role in strategic decisions of an international relocation company on the way the services abroad are organized with or without local partners. There are four distinct ways for organizing relocation services in foreign countries, namely (i) through the market, (ii) through a strategic alliance, (iii) through franchising, and (iv) through an own subsidiary. The first and last of these ways of organizing correspond to the respective Coasian archetypes: the market versus the hierarchy. The other two modes of organization are hybrid forms between market and hierarchy. The finding in the paper is that in the international relocation industry all four types of organization are used depending on the circumstances. The company of the case study appears to have a flexible and dynamic management with respect to the choice of the organizational form.

Changed circumstances may make it necessary to adjust the organization. It appears that in making these decisions the balancing of the various types of transaction costs, as distinguished in transaction cost economics, plays an important role. But in practice decisions are mainly made on the basis of intuition: no real comparative calculations are made with respect to transaction costs when making decisions on the actual way of organizing the relocation service. This paper provides an excellent example of how a case study on transaction management can look like. Unique is that this case considers a company from the business services sector and not, as in most previous cases, a company from the manufacturing industry.

In the discussion of the papers, and more in general in the discussion of the way transaction costs can be managed in hybrid organizations, the following questions were considered:

1. In what sense can transaction management contribute to the practice of a good choice of the organizational form in different circumstances and institutional environments? How about the distinction between production and services sectors?
2. What is the role of government in the valorisation of knowledge about hybrid organization in the business sector?
3. To what extent can the knowledge of hybrid organizational forms such as choices for public-private partnerships, also be important for the government itself?

Regarding the first question, all papers show the importance of theoretical arguments of transaction cost economics

in strategic decision making on what organisational form to select. Yet it is clear that such choices are almost always made in a rather intuitive way, without formal and quantitative calculations of the various transaction costs that will be encountered in different situations and with different types of organization. However, it seems that a more formal procedure of balancing various alternatives, like in the case of cost/benefit analysis, could be a useful contribution of transaction management to strategic decision making of firms in such complicated make or buy and location decisions. Most certainly, just as in cost-benefit analysis, a decision will never solely be based on sheer numerical outcomes, as always the gut feelings of the entrepreneur about uncertainties and challenges, which cannot be quantified nor codified, will have the final say in the decisions. On the other hand, a more formal approach of transaction management can be helpful as a tool which may provide support to the complex entrepreneurial decision making process. Here there may be an analogy with forecasters using econometric models. Their forecasts about economic developments – e.g., on economic growth in the next two years – are never solely based on the computer output from their models, but all kinds of judgemental elements, such as forecasts of exogenous variables and the use of so-called add-factors, are included in the final forecasts. In order to make transaction management more suitable for use in practice it should be on the research agenda to develop a methodology which allows the interaction between "hard" knowledge on transaction costs and intuitive entrepreneurial knowledge in a similar manner. The paper by Remo Corstjens suggests that such methodology should be even more flexible

in the case of the service industry than in manufacturing.

The Netherlands seems to have some comparative advantage in organising production in the hybrid form of a cooperation. One of the largest banks in the country, the Rabobank, originated as a cooperation and also a large multinational in the dairy industry, Friesland-Campina, is organised as a cooperation. Moreover, the Netherlands is a world leader in the Dance industry, which owes much of its success on the flexible way of organising Dance events using various kinds of hybrid forms of organisation (Den Butter et al., 2014; Joustra, 2014). This skill in being cooperative, and not hierarchical, in the way production of goods and services is organised in the Netherlands has to do with the tradition of being a trading nation where early in history citizens – "burghers" – and not monarchs were setting the rules. Yet it seems that making use of hybrid forms of organisation in modern times requires skills that are, at least partly, to be obtained through knowledge transfers. In that sense developing these skills and learning through experience to profit from these hybrid ways of organising economic activities brings about positive externalities. It implies that there is a role for the government to stimulate the development and transfers of this kind of organisational knowledge.

The discussion by the participants of the workshop clarified that the government itself may also make use of various types of cooperative agreements in their activities which aim at safeguarding the public interest. Today the choice is still too much between doing it yourself or outsourcing (part of) the activities to private partners in

the market. Making use of in-between hybrid forms of cooperation may in specific cases bring about less (transaction) costs in safeguarding public interests. One of the participants mentioned the very practical example of housing of the government services. Another example relates to the way the different governmental bodies (say Ministries) interact: when can activities be better organised by common standards and methodologies, and when do such cooperative devices bring about too high coordination costs? Yet, also in this case, more knowledge should be acquired on the best ways the government can make use of the various types of hybrid organisations.

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Goodwill and transaction costs

Erik Blokland

Introduction

Human perception on goodwill has vastly transformed through the last century. This alteration translated itself in the adoption of new accounting principles, adaptations of the definition of goodwill, and its increasingly paramount contribution to corporate valuations and acquisitions.

Dore (1983) emphasises the change in reflection on the concept of goodwill. Palgrave's 1923 dictionary of economics defines goodwill as: *the expectancy of a continuance, to the advantage of a successor in an established business, of the personal confidence, or of the habit of recurring to the place or premises or to the known business house or firm, on the part of a circle or connection of clients or customers* (Palgrave, 1923). Half a century later, McGraw-Hill's economic dictionary entails a different view on goodwill: *an accounting term used to explain the difference between what a company pays when it buys another company and what it gets in the form of tangible assets* (Greenwald, 1973). The goodwill concept is thereby extended to cover not just the benefits accruing to the purchaser of a business, supported by its customers, but also gaining from the subsequent shift from a competitor to monopolist – the acquired ability to control the customers by price-setting (Dore, 1983). The change in the standard definition of this term has been established by the increased dominance of the world by large corporations and their accountants' terms.

From a public policy perspective, goodwill accounting has also increased in importance (cf. Colley and Volkan, 1988). Currently, goodwill and other intangible assets constitute a substantially larger

fraction of the value of a firm, moreover, a larger portion of the acquisition price of purchased companies, than what used to be the case (Chauvin and Hirschey, 1994).

The novel belief in the United States that goodwill suffices all elements of an asset, as described in the Financial Accounting Standards (FAS), resulted in a change of computing the accounting book value of goodwill (Henning et al., 2004). From the market viewpoint, goodwill was earlier acknowledged to be an asset and its information incorporated in the valuation of the firm (McCarthy et al., 1995).

The aim of this paper is to provide a clear overview of what goodwill entails and how it is associated with transaction costs. The remainder of this paper will proceed as follows. First, an in-depth study will be obtained about the phenomenon of goodwill. In the subsequent section, its connection with transaction costs will be revealed. This transaction costs perspective will entail mostly qualitative characteristics. Finally, a short summary and conclusion of the main subjects will be given.

What is goodwill?

The purpose of this section is a sole focus on goodwill from accounting and financial points of view. First, a general picture of what goodwill exactly is will be portrayed. Second, prior research on acquisitions and overpayments of companies will be discussed. Finally, the difference between accounting and investor perspective on goodwill will be depicted.

Goodwill is an intangible asset on the balance sheet of companies. Therefore it is an asset not physical in nature (such as buildings or equipment are).

It is regularly called the 'sweat equity' a company has built during its existence. Namely, goodwill encompasses all the factors above and beyond book value which make investors willing purchase a business. On the whole, it represents the value of brand names, patents, customer base loyalty, competitive position and other hard-to-price assets a company might own. Goodwill also frequently arises at the acquisition of a company. It represents an acquisition amount in excess of the purchased firm's net assets valued on the balance sheet. Therefore the distinction between internally generated and purchase goodwill is often made (e.g., Chauvin and Hirschey, 1994). Normally, banks do not finance intangible assets such as goodwill. Either (other) investors or the firm itself is responsible for financing goodwill.

In case of excess payment for a company, a positive value of goodwill will emerge on the balance sheet. However, if a business is acquired for a price below the fair value of its identifiable assets and liabilities, the margin can be called 'badwill' or negative goodwill (Accounting Standards Board, 1996). Such purchases by nature imply a bargain and rarely occur.

Goodwill plays a bigger role in publicly traded companies than in private firms. This is because publicly-traded companies are constantly under public scrutiny and object to market valuation. Thus the actions and ethics of public firms are easier to see and quantify.

Falk and Gordon (1977; 1979) analysed various economic factors contributing to goodwill. The authors identified the relative importance of seventeen firm

characteristics, falling into four broad categories, including: superior ability to increase short-term cash flows, economic stability, good management and organisational structure, and 'exclusiveness' in terms of 'brand name recognition' and 'access to technology'. The most important characteristics appeared to be 'good labour relations', 'managerial talents' and 'production economies'. These results are in line with the findings of Nelson (1953) who argued that goodwill is associated with 'customer lists, organisation costs, developmental costs, trademarks and brands, secret processes and formulas, patents, copyrights, licenses, franchises and other identifiable sources of 'superior earnings power'.

Goodwill can be regarded as the discounted cash flows of current and future operations the firm executes or is capable to have (e.g., with a feasible opportunity to enter new markets or niches).

The capability to minimise transaction costs, due to aspects of goodwill such as good management and brand name recognition, is thereby financially internalised and quantified on the balance sheet of a firm. This long-term reduction in transaction costs could be both internal, such as being efficiently organised, and external, for example having a stable and reliable (trade) network.

Sharma and Ho (2002) demonstrate that corporate acquisitions do not lead to significant improvements in post-acquisition operating performance. Their study suggests that corporate acquisitions may be undertaken for other than synergistic reasons. Earlier studies such as Mace and Montgomery (1962) defined deviating

reasons for acquisition e.g. to safeguard raw material supply or maintain the skills of high-trained scientists or talented managers. Tearney (1973) found that the most often cited reasons were 'accomplishing a particular market objective', 'saving time in expanding into a new area', 'acquiring management and technical skills' and 'achieving product diversification' and 'integration'.

Churyk (2005) relates even more to the concept goodwill by describing reasons why purchasers may overpay for a target firm. He classifies them in two groups; the agency theory and the hubris motive. The agency motive states that managers have an incentive to act in their own self-interest at the expense of stockholders. Nevertheless, harming shareholders need not be intentional in this theory. For instance, when managers are not properly diversified, they diversify holdings of the firm to reduce the risk of human capital (Amihud and Lev, 1981). Another reason could be that managers will enter new markets in order to ascertain survival of the firm (Donaldson and Lorsch, 1983; and Jensen, 1993). In addition, when a manager's job becomes endangered by poor performance, he has an incentive to enter new lines of business at which he feels more confident (Shleifer and Vishny, 1989). Growth also creates promotion opportunities for junior managers without threatening the jobs of current top-level managers (Donaldson, 1984). Hubris occurs when managers issue bids based on inaccurate belief in their ability to manage the target firm or erroneous estimates of target firm value (Roll, 1986). Thereby they act against shareholders' interests, since founded on these mistakes in judgment, the acquirer overbids.

The hubris hypothesis has been supported by more recent studies; Morck et al. (1990), Berkovitch and Narayanan (1993), and Zhang (1998). Roll (1986) also found that purchasers, on average, pay too much for targets.

The manner of valuing goodwill once it has been recorded on the balance sheet has differed through time. Prior to 2002, it was an indefinite intangible asset. In other words, goodwill was perceived to have a limited useful life (i.e., legal and economic life). In that period, goodwill was amortised over its expected life cycle, similar to the depreciation of, for example, a production machine. The useful economic life of purchased goodwill is defined as the period over which the value of an acquired business is expected to exceed the values of its identifiable assets and liabilities (Accounting Standards Board, 1996). In the United States, the amortisation period had a maximum of 40 years (Johnson and Petrone, 1998). In the United Kingdom, the economic life was only allowed to exceed twenty years under strict circumstances (Accounting Standards Board, 1996). First, the durability of an intangible asset or business can be demonstrated and justifies estimating the useful economic life to exceed 20 years. Second, the goodwill is capable of continued measurement, viz. annual impairments will be feasible. Since 2002, U.S. companies have had to adopt new accounting rules (SFAS 141 and 142). This implies that goodwill must be tested at least annually to see if its value is still accurate. If the asset appears less worthy than the management originally paid for, an impairment charge is required in order to correctly reflect the asset's value on the balance sheet. The introduction of the rules concerned has been both ex-ante

(e.g., Chauvin and Hirschey, 1994, and Jennings et al., 2001) and ex-post (e.g., Churyk, 2005) widely argued and empirically justified in scientific spheres. Reducing the carrying value of goodwill to the fair market value represents a 'mark-to-market' charge; it aims to provide a realistic appraisal of the current market value rather than its book value. Therefore goodwill has become a definite asset; that is, having an unlimited useful life, although its value (still) is subject to change over time. As already recognised by the Accounting Standards Board in 1996, where goodwill and intangible assets are regarded as having indefinite useful economic lives, they should not be amortised. Since the introduction of the International Financial Reporting Standards (IFRS), all EU countries have to adopt their accounting process to the annual impairment tests. Therefore, the possibility of non-amortisation was possible prior to 2005, yet not uniformly applied.

A goodwill impairment charge is non-cash and therefore does not affect cash flows. However, it might entail a very poor estimation of the (purchased) company's value and potential during the acquisition and negotiation phase. In the case of HP's acquisition of Autonomy in 2011, it funded the purchase price through cash reserves. This decision resulted in the evaporation of multiple billions of dollars in shareholder value since the company was worth only a fraction of its earlier estimated value. The impairment of HP of an incredible amount of \$8.8 billion indicated that not only the poor estimation of the current management but rather the misrepresentation (of a company's financial state) from the former board can result in a subsequent impairment (Souppouris, 2012).

As the HP CEO Meg Whitman publicly announced: *'HP is extremely disappointed to find that some former members of Autonomy's management team used accounting improprieties, misrepresentations and disclosure failures to inflate the underlying financial metrics of the company, prior to Autonomy's acquisition by HP. These efforts appear to have been a willful effort to mislead investors and potential buyers, and severely impacted HP management's ability to fairly value Autonomy at the time of the deal.'* Remarkably, both Deloitte and KPMG audited the financials of Autonomy, but neither found any irregularities.

In 2002, AOL Time Warner admitted to investors that they overpaid \$100 billion in terms of goodwill, at the time the merger between AOL and Time Warner. In result, the share value of the company imploded by 75%. Moreover, if a company is constantly writing down goodwill, it implies that management has made poor decisions. Hence investors might want to contemplate their investments. Therefore not only a single impairment but a sequence of write-offs can lead to a negative alteration in shareholders' belief in the company. This disbelief often translates itself into a decline in share price.

A positive view on a write-off is that it also provides a more current value of assets on the balance sheet. During bubble years, balance sheets are signified by goodwill because of companies overpaying for assets by acquiring overpriced stock. Revealing the true value of those assets will not only improve the analysis of a company, moreover, what investors ought to pay for that stock. The attempt to enhance transparency since 2002,

right after global recuperation of the dot-com bubble, therefore not only critically evaluates management decisions but also leads to better estimates of the true underlying value of stocks. Nevertheless, other investors merely ignore the issue entirely.

A huge write-off should, however, not by definition be perceived as a bad sign. Indeed the impairment reveals bad decision-making regarding corporate management in the past. Nevertheless, by taking an all-encompassing charge, the managers demonstrate their honesty and good intentions regarding future events of the company. Although it is a huge blow for current investors, it is more favourable for the long-run than in case of a series of recurring impairment charges. Namely, this could eventually lead to a slow death of the company. Moreover, it could create an impression of the management manipulating reality by intentionally not admitting their faults and facing the consequences within a single step.

In conclusion, the level of overpayment and the subsequent drastic decline of purchased goodwill obtain most emphasis in scientific fields. More relevant, however, is the maintenance of goodwill after the transition of owners. Namely, this forms one of the major underlying causes of an impairment. The value of goodwill may be perfectly judged at time of acquisition, nevertheless, the responsibility is at the new owners to maintain, increase and, hence, realise their judged value. Their aptitude to control and convert the obtained assets in such a way that it will reach or exceed their predicted future outcome is therefore vital. In other words, the chemistry between the new

management and all other imaginable facets of a company has to be at least as good as in (the situation of the) former organisation to convert the purchased value of the obtained assets into attained cash flows. As the hubris hypothesis (Roll, 1986) addresses, overconfidence in the management's ability to manage the target firm (at least as good as its former staff) often leads to write-downs after acquisition.

Huge impairments due to inflated overpayments during the dot-com bubble are often the point of reference in examples of goodwill scandals (e.g. the aforementioned AOL Time Warner merger). What is not taken into account in many critiques is that impairments after bubbles occur in a different market trend. This is essential for both goodwill estimates at the moment of acquisition and impairment as future prospects highly diverge from each other. In an upward market trend, market dynamics flourish which makes the perspective on future revenues rosier. This positive disposition of the market causes higher purchased goodwill at acquisitions. Conversely, in a declining market, near future revenues reach timely lows, affecting prospects of a company's profit capability hence influencing the amount of corporate goodwill. Therefore the level of goodwill, being annually determined through impairments, will be highly dependent on the market trend in which a company operates. As in the previous paragraph, goodwill could be perfectly judged at a certain moment in time, the value of which being utterly irrelevant during different market evolutions. Obviously, this does not legitimise the entire impairment or 'misjudgement' as myriad other (mostly non-revealed) factors affect value judgments of goodwill.

Although goodwill is regarded as a definite asset nowadays, several remarks can be made. Goodwill is very hard to estimate accurately since its value can come from abstract and often unreliable phenomena. The ideas and people within an organisation, for instance, are both not guaranteed to work for a company forever. Therefore, different experts often end up with different valuations. In addition, the accounting rules (SFAS 141 and SFAS 142) allow considerable space for companies in allocating goodwill and determining its (carrying) value. For example, there are still possibilities within the allocation process to manipulate purposely in order to (unjustly) pass the impairment test. As managements still attempt to avoid these charge-offs, accounting scandals will certainly (re)occur.

Allocating goodwill to business units and its valuation is often a process hidden from investors. This non-transparent procedure provides the opportunity for manipulation. Moreover, companies are not obliged to disclose what exactly is determined to be the fair value of goodwill, which would help investors making a more informed investment decision.

An incentive to avoid impairment charges could be the negative effect on the company's ability to refinance its debts. The majority of lenders require the borrowing institute to maintain certain operating ratios. If a company does not adhere to these constraints (i.e. loan covenants), it could result in default of the loan agreement. In that case, the lender has all the power in renegotiation and repayment stages: for example, the investor has the right to demand an immediate repayment of the loan. Such a default (i.e., rejection of financing) is even more harmful

if the firm already has a large amount of debt and is in need of more financing. Therefore, investors, especially of companies in significant debt, should carefully evaluate their investments. A less optimistic view than the income statements and balance sheets attempt to convey, is in such cases (even more) relevant.

Investors appear to routinely value tangible assets different than accountants (Chauvin and Hirschey, 1994). Moreover, investors place significant economic value on intangible assets which do not meet accounting criteria. These divergences between market and accounting valuations lead to undermining confidence in the reliability and relevance of accounting data. They also provide motivation to improve in the accounting recognition and valuation of intangible assets (Wyatt, 1992).

In the study of Henning et al. (2000), the difference between the acquisition price and the pre-acquisition book value of the target firm's assets is decomposed into four components. Investors attach a significantly higher weight to the segments going-concern and synergistic value. Furthermore, they are positively related with market value. In other words, investors do not write off these portions of the goodwill asset in the year of acquisition, whereas they do with the other two (i.e., write-up and overvaluation). The value of the target as a going-concern, or stand-alone entity measures the difference between the target's pre-acquisition market value six days prior to the acquisition and the target's fair market value of assets. The market's appraisal of the synergistic value created by the acquisition pertains the combined cumulative abnormal returns to the target and the acquirer for the 11 days

centred on the acquisition announcement. The residual component depicts the difference between recorded goodwill and the synergy and going-concern components. Regressing the market value of equity on the three components indicates a negative relation between the residual component and market value, suggesting that overpayments reduce firm value.

The introduction of the new accounting standards (in 2002) ought to provide the investors more transparency about acquisition costs and more accountability for bad acquisitions. Hayn and Hughes¹ (2006), however, found that available disclosures on acquired entities do not provide financial statement users with information to adequately predict future write-offs. In addition, goodwill write-offs lag behind the economic impairment of goodwill by an average of three to four years, with one-third of the companies examined up to ten years. These revelations have two implications on aforementioned subjects. First, the delay entails the avoidance of write-offs being actually acknowledged at a certain point of time, indicating accounting manipulation. This finding is consistent with the results of Henning et al. (2004): U.S. firms delaying goodwill write-offs. Second, the attempted transparency has still not been attained since accounting manipulation and, consequently, inconclusive disclosures do not lead to the obtainment of current fair value of assets, essentially needed for investors to critically assess their (potential) holdings. Nevertheless, Chauvin and Hirschy (1994) state that, despite their well-documented limitations, accounting goodwill number can be perceived useful if investors include them in the valuation of individual firms. Accordingly, they can

capture important elements of a firm's intangible assets.

Gu and Lev (2011) discover that the root cause of many goodwill write-offs is the buyers' overpriced shares at acquisition. Overpriced shares incentivise managers to exploit the overpricing by acquiring businesses, often spending more than the acquisition's synergies, leading to subsequent goodwill write-offs. They found the following patterns: firstly, share overpricing is strongly and positively related to the intensity of corporate purchases and the growth of accounting goodwill. Secondly, share overpricing predicts goodwill write-offs and their magnitude. Thirdly, acquisitions by overpriced companies are often ill-advised, aggravating the post-acquisition negative returns of buyers beyond the reversal of the overpricing. Therefore, goodwill write-offs highlight a dysfunctional investment strategy.

Transaction costs

This section concentrates on the economics of transaction costs in relation with goodwill. After a brief definition of transaction costs and its forms, the connection will be made with goodwill.

Transaction costs involve all of the costs associated with conducting exchanges between firms and can be decomposed into ex-ante transaction costs, or search and contracting costs, and ex-post contracting costs, or monitoring and enforcement costs (cf. Williamson, 1985; Hennart, 1993; and North, 1990).

1 The sample comprises acquisitions that occurred both before and after the introduction of the SFAS 142.

More recent research has also acknowledged transaction costs to occur within firms (e.g., Dyer, 1997; Madhok, 1996; and Stavins, 1995). The conception of transaction costs will therefore encompass both intra-firm and inter-firm transactions in the remainder of this paper.

Goodwill forms part of the intangible assets, which includes the (distinctive) capabilities for a company to hold transaction costs low. This could be trust or reputation, facilitating transactions, as will be further discussed. Moreover, intangible capital such as talent, specific business insights, field experience and excellent teamwork form possibilities. Hence this variety of aptitudes is quantified since an accurate estimation of goodwill is required on the balance sheet.

Components of goodwill can reduce transaction costs both within and between entities. For instance, high human capital, such as great teamwork, and business intelligence increases productivity by reducing transaction costs between departments and among employees (Ciborra and Olson, 1988). As the word implies, internally generated goodwill therefore is able to reduce internal transaction costs. The value of brand names also appertains to goodwill. As discussed further, a good brand name facilitates cooperation with other corporations and thereby reduces the transaction costs to find and work with a business partner. Furthermore, customer base loyalty reduces the transaction costs compared to exchanges with non-loyal consumers. In other words, goodwill is able to reduce both internal and external transaction costs.

A distinction between 'hard' and 'soft' transaction costs can be made (Den Butter, 2011). Hard transaction costs include observable costs such as transport costs, import duties and customs tariffs. Soft transaction costs consists of all costs of unwritten laws, trust building, networking, risk costs, making and monitoring contracts, information costs, etc. Since the typical ethereal nature of the assets forming (the value of) goodwill make the associated costs very difficult to observe, (gaining) goodwill thus represents soft transaction costs. Nevertheless, as will be discussed in following paragraphs, accounting and tax laws exert influence on goodwill as well. Therefore hard transaction costs are involved in the attainment of goodwill and its consequent value.

Chauvin and Hirschey (1994) reflect on important measurable implications of goodwill. For instance, firms with a high-quality reputation reduce customer search costs. Conversely, firms with a reputation for low quality increase necessary customer search costs. The time and (thus) money invested in obtaining (loyal) customers can be seen as transaction costs – which a good firm reputation reduces.

Given the fact that consumers often have difficulty with accurately assessing firm quality, firms have an urge to signal quality to consumers in the course of investment and marketing decisions. Hence, high-quality firms can be expected to invest vastly in Research & Development (R&D), brand-name advertising and other reputational purposes. The value of such investments would be vanished in case of the production of low quality goods. Therefore a great (financial) commitment to these expenditure domains is

demonstrated to maintain the provision of high-quality goods. This leads to the expectation of advertising and R&D expenditures giving rise to valuable intangible capital. Moreover, empirical evidence demonstrated that expenditures on R&D and advertising both exert a positive influence on goodwill (Chauvin and Hirschey, 1994). This influence is quantified in the study of Cleeve (2009) in which goodwill is proxied by the ratio of media advertising to sales of a company. If such aspects of valuable reputational capital are captured by current accounting practice, goodwill numbers will exert a positive influence on net income and the market value. However, according Chauvin and Hirschey (1994), a conflict between negative reporting effects and positive economic effects obstructs determining the economic influence of accounting goodwill data on net income. In the eyes of the author of this very paper, the usage of valid control variables for economic effects could clear up this causal ambiguity.

Accounting goodwill numbers are therefore seen as a functional, albeit imperfect, indicator of intangible assets, which intensifies profitability (Chauvin and Hirschey, 1994). Similarly, accounting goodwill numbers are regarded as a potential indicator of the essential intangible asset dimension of the value of the firm. Therefore the inclusion of goodwill on the balance sheet, in particular if subdivided in different expenditure sections, could be time-saving to approximate the amount of intangible assets (in comparison with less accurate proxies). In other words, the accounting goodwill numbers of a firm reduce the transaction costs for an external party (e.g. an investor) to obtain information about the size of the (most important)

intangible assets (and possibly future profits) possessed by a firm. Furthermore, it appears that companies have revealed new information about the value of goodwill to market participants since the introduction of SFAS 142 (Li et al., 2006). A significant negative correlation between an impairment loss and post-acquisition returns of impairment firms was also found. This increased market efficiency, due to the new accounting rules, also reduces the transaction costs of obtaining an accurate view on the actual goodwill and returns of a firm.

Moreover, investors regard these admittedly imperfect data as proxy useful for (the influence of) amongst others good management, brand-name recognition and good customer relations. One can therefore infer that accounting goodwill numbers offer a useful perspective on the hard-to-measure reputational value component of the economic value of the firm. Naturally, this very data is commonly believed to curtail transaction costs to estimate the (relative) reputational constituent and significance of a firm.

The aforementioned implications on transaction costs thus reduce the time and can increase the accuracy in the decision-making process for investors. Goodwill arises at a transaction, namely at an acquisition or merger. It thereby forms part of the costs in the trade of companies. Bugeja and Gallery (2006) focus on the perception on the representation of this very part of the total costs of a corporation. They discover that the value relevance of acquired goodwill is vanished three years after the acquisition. The interpretation of this result suggests either that the market takes approximately three years to realize that the balance of goodwill will not result

in economic benefits or that the economic benefits of goodwill are consumed rapidly. The first possibility is in line with corporate acquisitions not achieving operational improvements for the merged company, being supported by, e.g., Sharma and Ho (2003). Therefore the view of investors rather implies the fact that the value of the acquired goodwill becomes a mere number, after three years of existence on the balance sheet, rather than the discounted future benefits of these intangible assets. Due to the absence of relevant content, one might argue that, after three years, it can be regarded as the amount of money to make the acquisition (i.e., transaction) possible. In other words, from a market perspective, the value of purchased goodwill purely encompasses the transaction costs required for the acquisition to take place.

The legal implications of different accounting principles result in (relative) tax benefits. Firms located in Japan and Germany, for instance, enjoy advantageous accounting and tax treatments relative to U.S. based companies (Lee and Choi, 1992). Regression analyses demonstrate that goodwill accounting explains merger premia. Although the tax benefits are available in both Japan and Germany, more favourable accounting treatments in Germany lead to a higher average premium. Therefore, U.S. acquirers, from a legal perspective, have higher transaction costs than non-U.S. acquirers with beneficial treatments despite the, on average, lower acquisition premium they pay. Choi and Lee (1991) also apply this comparison to U.S. and U.K. acquirers of U.S. target firms. Merger premia by U.K. purchasers were consistently higher than those for U.S. acquisitions. The higher premiums offered

by U.K. firms appear to be associated with not having to amortise goodwill to earnings. The national differences in accounting impact differentially on managerial behavior. Therefore the difference in premiums offered can, again, be attributed to the transaction cost implications of distinct accounting principles. However, the first steps to convergence of IFRS (i.e. international accounting standards) and Japanese Generally Accepted Accounting Standards (GAAP) were set in December 2009 (IFRS, 2014). Therefore, the validity of this difference in accounting standards, hence its implications on merger premia, in Japan and Germany (honouring the IFRS) could be questioned in the following decades.

Trust is one of the most recognised aspects of goodwill in relation with transaction costs. For example, goodwill trust, defined as the ability to rely on customers to help in ways not required by the company's agreement with them, is significantly associated with cost reduction (Sako and Helper, 1997). High trust was linked to the fact that suppliers were able to increase the frequency of delivery without increasing costs in the U.S. and Japan. In Europe, high goodwill trust significantly enhanced Just In Time (JIT) delivery. Furthermore, perceived trustworthiness reduces transaction costs and is correlated with greater information sharing in supplier-buyer relationships (Dyer and Chu, 2003). The value created for transactors, in terms of lower transaction costs, may be substantial.

From a less logistic perspective, trust may also reduce transaction costs with an exchange partner in myriad ways. For instance, trust diminishes the need for formal contracts, being costly to write,

monitor and enforce (Hill, 1995). This relation is explained by the fact that both exchange partners are confident that payoffs will be fairly divided (Kramer, 2006). Thus, trust supports negotiating efficiency by enabling both sides to be more flexible in granting concessions because of the belief that the exchange partner will return value in the future (Dore, 1983). This allows transactors to achieve 'serial equity' (equity over a longer period of time) rather than requiring immediate or 'spot equity' (Ouchi, 1984; and Dyer, 1997). As a result, it reduces the necessity for traders to invest heavily in ex ante bargaining. Additionally, negotiations are expected to be more efficient because transactors will have greater confidence that information provided by the other party is truthful. Similarly, according to Zaheer et al. (1998), 'trust reduces the inclination to guard against opportunistic behavior.' In other words, trust curtails the fear (thus expectancy) of deliberate misrepresentation on the part of the exchange partner. Therefore Zaheer et al. (1998) found support for a negative relationship between inter-organisational trust and negotiation costs. In addition, transactors are more likely to share valuable work-related information when they have developed in a high level of trust (Sako, 1991, Nishiguchi, 1994, and Uzzi, 1997). Therefore the willingness to not only distribute truthful but also more valuable information between partners is created by trust.

The nature of inter-organisational relationships depends on the interaction between the logic of transaction costs and the need for trust and interdependencies between exchange parties (Banduchi, 2008). Cleeve (1997) described cultural differences in sharing goodwill with joint

venture partners. Japanese corporations consider transaction costs to be vital at the decision between part and full ownership of their U.K. subsidiaries. The bigger the goodwill capital, in this study signified as the 'brand name', the more likely a Japanese firm is to choose for full ownership. It seems that those firms are particularly concerned about free riding by joint venture partners on their 'name'. For example, most 'big name' Japanese companies operating in the U.K. are wholly owned by their Japanese parents e.g. Nissan, Sony and Toyota. For the U.S. based parent firms, this relation is statistically insignificant, implying cultural differences in management decisions. These results have three implications regarding transaction costs. Firstly, Japanese firms have joint ventured in the U.K. in order not to take entirely account for the uncertainty and risk of foreign production. Secondly, when companies are producing completely different products to those of the parent firm, they need inputs from local corporations normally engaged in this type of business. Thirdly, Japanese enterprises need to joint venture with U.K. firms to gain access to resources held by local firms. From a U.K. based firm perspective, this means that the transaction costs are relatively high to cooperate with Japanese firms (in the form of joint ventures) since they are required to possess assets non-held by the Japanese corporation. These assets include, amongst others, time and experience in a certain business and knowledge of the U.K. market, entailing that goodwill capital is an essential predictor of the nature of co-operation. Furthermore, goodwill thereby forms a large part of the transaction costs to attain a joint venture with Japanese firms. Lastly, acquiring or merging with a company in an industry the purchaser is not active in might be result in

lower costs than settling itself in that field. Therefore transaction costs might be lower for companies to acquire a company than fully account for all start-up costs. Moreover, the risk of failure is being spread.

From a public policy perspective, goodwill accounting has increased in importance (Colley and Volkan, 1988). At present, goodwill and other intangible assets constitute a significantly larger fraction of the value of a firm, moreover, a larger portion of the acquisition price of purchased companies, than used to be the case (Chauvin and Hirschey, 1994). To visualise this share of a firm's value, a comparison between goodwill and shareholders' equity for the largest four banks in the Netherlands is made. The information concerned is obtained from statements of financial position in annual reports of the banks². A short analysis will be run on the most recent two calendar years.

For ABN AMRO, the reported goodwill was €132 million (m) and €134m in respectively 2011 and 2012. The total shareholders' equity (SE) comprised respectively €11,400m and €14,018m in these years. Therefore the value of goodwill compared to SE is 1.16% and 0.96%.

In case of ING, its goodwill comprised €1,179m and €1,188m. The SE accounted for €34,367m and €36,669m. The share of goodwill in SE is therefore 3.43% and 4.45% respectively.

At the end of 2011 and 2012, SNS reported goodwill values of €1,416m and €857m, and SE pertains €5,089m and €3,350m, respectively. Therefore goodwill is worth 27.8% and 25.5% of the SE value. Interesting is the fact that SNS differentiates between goodwill and value of business acquired (VOBA) in their reports. Therefore internally generated goodwill (respectively €553m and €234m) is being divided from the purchased goodwill (respectively €863m and €623m). As both did not decline proportionately, the change in share of total goodwill also changed. In both years, purchased goodwill formed the majority of the total goodwill; with 60.94% in 2011 and 72.70% in 2012. Therefore internally generated goodwill depreciated relatively more than purchased goodwill. Whether the impact of goodwill on lowering (future) transaction costs differs between the two, and to what extent, cannot be explained with the information from the corresponding annual reports. From a market perspective, internally generalised goodwill will have more influence as, on the long run, purchased goodwill is perceived to be the sole costs of a transaction to occur. Moreover, achieving operational improvements are often absent for the merged company (Sharma and Ho, 2003). Internally recognised goodwill will therefore be a better valuation of the competence to reduce transaction costs than purchased goodwill (which is initially purely determined by the excess payment at an acquisition).

In case of Rabobank, the SE was €43,220m and €42,325m in 2011 and 2012, respectively. The goodwill pertained €1,903m and €1,523m, forming 4.40% and 3.60% of the total SE.

In comparison, the reported goodwill of Rabobank was largest in both cases.

The value of ING was higher than SNS in 2012 whereas SNS reported more in 2011. Remarkable is that ABN AMRO reports by far the lowest goodwill. Although both ING and Rabobank possess significantly more shareholders' equity, ABN AMRO reports less than 10% of the goodwill value of SNS, whereas the SE is more than twice as large and four times as high in, respectively, 2011 and 2012. Whether this utterly low goodwill value is due to the management's honesty or genuinely substantially lower goodwill capital remains unanswered. As a result, the value of goodwill in relation to the SE is relatively low for ING and fairly high for SNS whereas the moderate share between 3.50% and 4.50% is present in case of ABN AMRO and Rabobank.

For ABN AMRO and ING, their reported goodwill slightly increased whereas the value of goodwill for the remaining two banks heavily decreased. Once more, an analysis is conducted on four companies, this time from different industries. They all share a tremendously high brand value, as they form part of the top 10 companies of the Best Global Brands 2011 ranking composed by Interbrand³. As the value of brand names (and corporate reputation) appertains goodwill, it is interesting how the estimated values of corporate brand names relate to the reported goodwill on the balance sheets of these years. Therefore the brand value and reported goodwill of 2011 are compared for the following companies: Coca-Cola, IBM, General Electrics and Disney.

Before the actual results are presented, the difference between brand value and brand equity has to be made, as explained by Tiwari (2010). Brand value is how management and shareholders value the

brand. It represents the net present value of future cash flows from a branded product minus the net present value of future cash flows from a similar product. Brand equity is what a brand is worth to customers. It is a set of elements that help distinguish one brand from another e.g. brand associations.

As goodwill is more relevant to shareholders and management than consumers, and the first two having formed the perspectives in this paper thus far, the author decided to compare goodwill with brand value rather than brand equity.

First placed Coca-Cola mainly produces in the beverage industry and reported \$12,219m of goodwill. As they produce beverages which are consumed in both economical highs and lows, Coca-Cola has a relatively stable return through time. As Falk and Gordon (1979) described 'economic stability' as one of the main characteristics of the value of goodwill, this could well be an explanation of their goodwill value. Interbrand estimated the brand value to be \$71,861m which is significantly higher than the reported goodwill.

Following Coca-Cola on the rankings, IBM concentrates its activities on Business Services and obtained \$69,905m of estimated brand value. Again, the brand value is substantially higher than the reported goodwill, being \$26,213m in 2011. Media magnate Disney was ranked ninth by an approximation \$29,018m. The value of goodwill in 2011 was relatively close with \$24,145m.

2 Available at <http://www.abnamro.com/nl/about-abn-amro/reports-and-reviews/index.html>.

3 Available at <http://www.gfmag.com/tools/global-database/economic-data/11936-best-global-brands.html#axzz2X8REk3Bg>.

Lastly, General Electrics became fifth with a brand value of \$42,808m and reported goodwill of \$72,625m in the very same year. Thereby this company, active in various industries, deviates from other three companies as the reported goodwill is actually higher than their brand value. The fact that they produce goods in diversified industries indicates their potential to expand to and grow in new markets, of which good management and networking may be explanations to (currents) success. As mentioned in the previous chapter, all these factors contribute to the amount of goodwill.

If the calculations of Interbrand appear to be correct, the goodwill of the first three companies would be undervalued. Namely, brand (name) value only forms part of the total value of goodwill. Hence the value of reported goodwill should at least be as high as the amount provided in the rankings. A possible explanation could be that the IFRS restricts the variety of developments in a company to represent goodwill. Therefore not all the value of the developments concerned can add value to goodwill on the balance sheet.

However, the results of brand value estimations should be interpreted with care as both the amount of value and, hence, the rankings differ substantially from other ranking lists. For instance, Marlboro forms part of the top 10 brands in the 2011 ranking of MillwardBrown Optimor⁴ whereas it does not in the case of Interbrand. Moreover, the reported brand value of Disney is judged \$12,000m less in the list of MillwardBrown.

Interesting is the fact that Coca-Cola reported the smallest amount of money on the goodwill account, nevertheless, was estimated the highest brand value. However, a small value of goodwill is nothing bad since impairments typically imply a decrease in goodwill. As this affects the earnings and thus profit of a company, keeping the value of goodwill low is often regarded as a safer option. Moreover, higher goodwill implies more susceptibility to impairments, as it has to account for more value.

If one compares the reported goodwill of the biggest brands to the Dutch banks, that person will conclude that the goodwill of those banks in 2011 did not exceed \$2,000m. Coca-Cola, demonstrating by far the lowest accounting goodwill among the non-banking companies in study, exposes goodwill approximately 6 times greater than the abovementioned amount. An explanation of this difference could be the following. Banks make profit on the spread between the received and their invested capital. Coca-Cola produces a large variety of products rather than the fairly homogenous (financial) products of banks. The Coca-Cola Company sells a myriad of brands, therewith obtaining a high potential for growing cash flows. In the banking sector, the biggest corporations such as JP Morgan, Goldman Sachs and Morgan Stanley are able to differentiate from others by functioning as leading underwriter in a deal (e.g. issuing new stock). Therefore they can ask higher fees than the average bank, being a capability forthcoming from the brand name and reputation. This could therefore end up on a balance sheet. The Dutch banks, however, are too small to offer this service and thereby their cash flow

generation is relatively limited, explaining lower reported goodwill. Therefore market capitalisation, reputation and homogeneity of products and services offered are the main reasons for the difference in goodwill value in this comparison.

Conclusion

Goodwill is generated at times of transactions. More specifically, the value is created at mergers and acquisitions when it is being approximated and subsequently paid for. Furthermore, goodwill has become an increasingly substantial component of the total costs of a company.

Goodwill accounting and recent impairments remained, despite several attempts (by for example Accounting Boards), rather controversial, leading to different perspectives on the subject matter. This was mainly due to the non-transparent procedure of valuing goodwill and several accounting scandals in this sphere.

Factors of goodwill have been scientifically identified, of which many are neatly related to transaction costs. For instance, goodwill comprises the (intangible) ability to generate future cash flows and holding transaction costs low. Aspects such as good management, stable markets and networking enable these capabilities to exist both within and between firms. This ability of a firm is also highly influenced by its management, making it a challenge for newly appointed managers (at corporate transactions) to convert the expectancies and current value of goodwill into realised cash flows.

Trust and reputation are highly valued aspects of goodwill as it facilitates transactions between both business partners and consumers. Therefore better goodwill results in (a) lower (need for soft) transaction costs. Co-operation with local firms abroad appears to be influenced by culture, having several implications on transaction costs for and the form of interaction with big brands. Hard transaction costs can be found in more and less favourable accounting and tax standards regarding acquisitions across nations.

The value of goodwill varies between the 3% and 25% of total shareholders' equity at the largest Dutch banks. The value of goodwill at the biggest brands in other sectors form a multiple of that of banks due to, amongst others, higher market share, reputation and homogeneity of goods produced.

4 Available at http://www.millwardbrown.com/libraries/optimor_brandz_files/2011_brandZ_top100_report.sflb.ashx.

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Licensing and transaction costs

Jeroen de Nie

Introduction

Firms increasingly trade in tasks rather than products (Den Butter, 2012). No longer are products solely produced in-house, but firms specialize on distinct tasks in production and outsource other tasks. This asks from companies to change their ways in which they organize their transactions. There are multiple ways in which companies can divide tasks. Examples are joint ventures, partnerships and licensing. What makes licensing especially interesting is that it does not involve the selling of tangible goods, but the transfer of knowledge. Through this, licensing provides an interesting opportunity to divide tasks between companies. That is, via licensing, the innovation process can be performed by a different company than the production process.

This paper investigates the consequences of choosing licensing with respect to transaction costs. The question is what are the environmental conditions that make licensing a viable choice. In the first part I explain what licensing precisely is and elaborate on what specific circumstances lead to companies to choose for licensing. In the next part I elaborate on the concept of transaction costs and the role of hybrids in keeping transaction costs low. Then I introduce a transaction costs framework that links transaction attributes with institutional arrangements and governance structures to minimize transaction costs. The last section applies this framework to licensing in order to find out what the relationship is between licensing and transaction costs.

Licensing

Traditionally, firms sell tangible products. With licensing, it is not a physical product that is sold, but rather the right to use an intellectual property right owned by the selling firm. Intellectual property is what is called “the creations of the mind” (WIPO, n.d.). Examples are patent rights, trademarks, copyrights, design rights and database rights. Roughly speaking, patents protect inventions, trademarks protect signs of products and services, copyrights protect creative expressions, design rights protect the external appearance of products and database rights protect compiled data in databases (Jansen, 2013).

Typically, R&D efforts of companies are capital intensive and long term investments (Atun et al., 2007). A strong incentive for firms to engage in R&D is to differentiate from competitors through innovation (Atun et al., 2007). However, they are only willing to invest in R&D when their results are safeguarded against imitation and copying. This is where intellectual property rights come in. These allow firms to not only sell their products and thus their patrimonial rights, but also their intangible innovations and processes. This furthers the possibilities to capitalize on innovation, since there are limits to what one firm can produce. By involving other firms in the utilization of the innovation, the innovating firm can increase total production output by producing itself, as well as let licensees produce. Another option is to choose to specialize in innovation and leave the production to companies that are specialized in production. This is especially relevant, because it is only worthwhile to invest in R&D when a company has the complementary capacities (i.e. marketing, competitive manufacturing and after-sales support) to create value from there innovations (Teece, 1988).

Arora and Fosfuri (2003) argue that small companies will find it more beneficial to license out, than do large companies. This is due to the stronger position of larger companies and the risk of losing competitive power through licensing. However they also found that, when smaller rivals do license out in a particular industry, larger companies tend to license out more as well. In general, Individual firms can find it profitable to license out patents when competitors have substituting technologies. A goal can be, for example, to set a technology standard. By doing this, their profit may decrease due to increased competition by licensees. But, when the revenue effect, which is the increased turnover, outweighs the rent dissipation effect, the decrease in turnover by increased competition, then a firm will find it profitable to license out (Arora and Fosfuri, 2003). However, when products are highly differentiated, it becomes less attractive to license out. Then, rent dissipation, due to stronger competition from the licensee relative to other competitors of the licensor, outweighs the revenue effect (Arora and Fosfuri, 2003).

Transaction costs

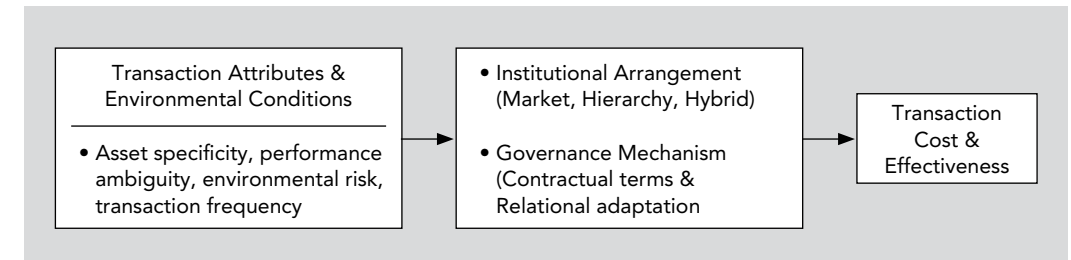
"Transaction costs can be defined as the costs incurred in coordinating and connecting all parts in the production chain." (Den Butter, 2012, p. 49) These transaction costs can occur within the company through the hierarchy, called vertical transaction costs, or between companies via market mechanisms, called horizontal transaction costs (Den Butter, 2012).

A method to keep transaction costs low is the use of hybrid organizational forms (Den Butter, 2012). In hybrid organizations, transactions not only take place through the market, nor solely through hierarchy, but are performed using both methods (Douma and Schreuder, 2013). Moreover, within hybrids, property rights are distinct, but decisions are made jointly (Ménard, 2008). Furthermore, firms within a hybrid are separate legal entities, but have set up a governance system to coordinate transactions within the hybrid (Ménard, 2008).

Licensing is a form of hybrid organization. The licensor and the licensee are distinct legal entities. In addition, transactions through licensing are partly achieved through the market and partly through mutual decision making. Namely, the transfer of the right to use the licensor's property rights is done through exchange, but certain rules are attached. That is, the ownership stays with the licensor and the licensee can only use it when it complies with certain mutually agreed upon rules. These rules can for example stipulate during what term the license may be used and in what region.

Therefore, when licensing is a hybrid form of organization and hybrids are used to minimize transaction costs, it is important to know what the effect of licensing is on transaction costs. Yang et al. (2012) provide a framework that links transaction attributes and environmental conditions to government structures and consequentially determine transaction costs and effectiveness (Figure 1). It states that transaction attributes, environmental conditions, institutional arrangement and governance structure should all be aligned

Figure 1. TCE Framework (Yang et al., 2012)



to minimize transaction costs and therefore maximize performance (Yang et al., 2012).

Transaction Attributes & Environmental Conditions

Transaction attributes are characteristics of transactions that determine transaction costs (Ménard, 2008). According to Ménard (2008) the commonly used transaction attributes are asset specificity, uncertainty and frequency. Asset specificity refers to the degree to which investments made in a transaction are transferable to other transactions without loss of value (Ménard, 2008). Investments made before and during the transaction differ in their ability to be readily deployed in other transactions (Riordan and Williamson, 1985). For example, investments that are made to negotiate the terms of the transaction are not readily deployable in other transactions when the negotiations are terminated. Furthermore, certain costs incurred during the transaction do not yield benefits when they are transferred to other transactions (e.g., transportation costs). This results in the party that has these sunk costs invested in the transaction to have a serious stake in the continuation of the relationship (Riordan and Williamson, 1985). Because contracts can be renegotiated with mutual

consent, there is a possibility to divide the rent on this sunk investment (Malcomson, 1997). This in turn can lead to hold-up behavior by the party who has not made these specific investments (Malcomson, 1997).

Another transaction attribute is uncertainty. Uncertainty refers to the beforehand unknown outcome of the transaction due to agent's behavior, organizational deficiencies, inadequate institutions and the state of nature (Ménard, 2008). Lastly, the frequency refers to the number of times a certain transaction takes place (Ménard, 2008). However, the effect of frequency of a transaction has not been extensively researched and several studies have found no relation between frequency and governance structure (Rindfleisch and Heide, 1997). Therefore I will not use this concept in this paper. Asset specificity and uncertainty generally increase transaction costs (Ménard, 2008). Yang et al. (2012) divide the uncertainty attribute further into performance ambiguity and environmental risk. Environmental risk pertains to technological, behavioral and market risk (Yang et al., 2012). Whereas performance ambiguity relates to the difficulty of measuring a partners performance (Yang et al., 2012). Furthermore, Yang et al. (2012)

argue that newness of technology has a positive effect on performance ambiguity.

Institutional Arrangements

Institutional arrangement refers to what degree business processes in the supply chain are carried out within a company or between companies (Yang et al., 2012). When these processes occur within a company, they are coordinated via the hierarchy (Yang et al., 2012). In organizational hierarchies, higher level employees set or ratify objectives and policies for lower level employees. These lower level employees then carry out the actions to comply with these policies and attain the corresponding goals. In turn, the higher level employees are responsible for making sure the lower level employees perform these actions adequately (Ouchi, 1978). On the other hand, when supply chain processes are divided between different companies, the transfer takes place via the market (Yang et al., 2012).

For example, a car manufacturer can decide to make its own wheels. Then certain employees will be appointed to perform the actions necessary to produce these wheels. The coordination is then done via the hierarchy. However, when the car manufacturer decides to purchase these wheels from an outside vendor, it uses the market. And coordination is done through communication with the vendor via prices, technical requirements and contracts.

A middle ground between hierarchy and market is a hybrid. Hybrids do not solely coordinate tasks via the hierarchy nor do they via the market. They perform certain tasks via the hierarchy and others via the market. The degree to what is coordinated

through the hierarchy and what is coordinated through the market is not set, but can vary between cases. Therefore hybrids are placed on a continuum between Hierarchy and market (Ménard, 2008).

Governance mechanisms

Governance mechanisms can be divided in two categories, namely contractual terms and relational adaptation (Yang et al., 2012). Contractual governance is a more formal form of governance involving the use of contracts. By using contractual governance, parties determine ex-ante rules to minimize opportunism (Yang et al., 2012). Still, opportunistic behavior can occur when one party displays behavior that is not in line with the expectations of the other party, but does conform to the explicit agreements in the contract (Muris, 1981). This is possible because of the bounded rationality of the parties. They are not able to foresee all of the circumstances that might occur after the agreement. Therefore they cannot anticipate the other party's behavior as a response to these circumstances and thus cannot include terms in the contract that align that party's behavioral response with the intentions that gave rise to the contract in the first place.

This is where relational adaptation comes into play. Relational adaptation is described by Yang et al. (2012) as informal buyer-supplier cooperation mechanisms. Examples are jointly solving problems, the sharing of information and buyer supplier collaboration (Yang et al., 2012). These governance mechanisms are in affect after the initial agreement has been made. This way they serve as a way to solve some of the problems that were not foreseen due

to bounded rationality. These two governance mechanisms do not substitute each other, but are complements (Yang et al., 2012).

Transaction attributes and environmental conditions applied to licensing

The framework from Yang et al. (2012) argues that the choice of institutional arrangement should be adapted to the transaction attributes. In the following, I argue that the choice for licensing as an institutional arrangement also effects the transaction attributes. This in effect influences the transaction costs. Furthermore, I elaborate on what environmental risks would make licensing a good choice to lower transaction costs. I do this by elaborating on the licensing of patents.

When a company has an invention that is new, industrially applicable and non-obvious, it can file for a patent right (Jansen, 2013). This prevents other companies from selling the same product and thus safeguards the invention. When the patent is in place, the company can capitalize on the invention by either using it in products they sell or by licensing out the patent, so other companies can make products with it.

7.1 Asset specificity

The licensing of patents could possibly involve more transaction specific investments than the selling of goods during the negotiation phase. This is due to the increased risk of not allowed use of knowledge owned by the licensor. This could especially be relevant for high tech products. When a company sells such a product, it sells a tangible item that does not directly reveal how it is made.

However, when it licenses patents, they essentially hand over the insights into how to make the product. Off course this is exactly what a license is for. However to be able to sell the innovation to multiple licensees it is important for the licensor to set rules as to in what region and for what period the innovation can be used by the licensee, so he can license to other licensees as well. Investments made to establish these rules are not necessarily readily transferable to other transactions. Therefore they add to the asset specificity of this type of transaction and thus increase transaction costs.

What is more, is that the possibility of not foreseeing all the contingencies beforehand due to bounded rationality gives rise to opportunities for the licensee to display hold-up behavior. This hold-up behavior further increases transaction costs.

However, licensing could also decrease asset specificity. This is due to the fact that a licensing offering is less customized to the needs of the end customer than a product offering. When deciding on the features of a product, the producer has to estimate what the needs of the clients are. Consequently, it has to make investments to be able to incorporate these features into the product. When the needs assessment is not accurate, the demand for the product will drop. When this happens, the investments to determine the needs and the subsequent investments to make the product according to these needs will not create the calculated rents. When these investments are not readily transferable to other products and thus transactions, these will be lost. This is less of a problem for licensing. Because the licensing offering is applicable to more

products, it is less narrowly defined to end-customer needs. Therefore, less transaction specific investments should be needed. An extra advantage in this sense is the time and effort that is saved due to the fact that a licensor does not have to design and produce products. In this time the licensor can work on other innovations and thus increase its portfolio. When it diversifies its innovations sufficiently it has more chances of making an innovation that is high in demand.

7.2 Performance ambiguity and newness of technology

Yang et al. (2012) found that newness of technology had a positive effect on performance ambiguity. One could argue that the most interesting time to license patents is when they have just been filed and thus when the underlying invention is new. This is because, when the invention is new, all possibilities to apply the invention are still new and have not been yet been exploited. Because the underlying technology is so new, it is difficult for the licensee to determine beforehand if it will truly reap the calculated benefits from it.

But not only when the underlying invention of the patent is new, will there be ambiguity to its usefulness, this is also true when the patent has been around for longer. This is because in contrast to buying products, the licensing of a patent requires the subsequent application of this patent. Since the patent will be used in the production of a new product it is not ex-ante necessarily certain whether the patent will have the expected effect on the development of the product. These two factors combined make it difficult for the licensee to determine ex-ante whether the licensor will fulfill his needs. This in turn

places a burden on the licensor to provide evidence to the licensee of the offering. Consequently adding to the transaction costs for the licensor.

For example, when a company wants to buy a machine to make computer chips, the procurement team only needs to know the specifications and they know which machine is suitable for the task. However, when that company is developing such a machine itself the engineers might have an idea as to what kind of technologies are needed in order to make the machine, but do not know what these technology exactly entail (because if they would, they would not need to license them from a vendor). Furthermore, in the development of the machine, different innovations need to be combined. It is uncertain if the different licensed technologies are combinable. Because of this ambiguity, the licensor needs to convince the licensee to the usefulness of its innovation. This requires extra investments and thus extra transaction costs.

Another way in which performance ambiguity is affected by licensing, is by the difficulty that exists for the licensor to measure the compliance of the licensee with the established rules of the licensing agreement. The only way in which a buying firm of goods can chose not to comply with agreements is by not paying. In contrast, a licensee has multiple options not to comply. For example, it can chose to use the patent outside of the agreed upon geographical area. Or it can chose to use the patent for a longer period of time than was agreed upon. It is difficult for the licensor to detect these sorts of behavior, because it would have to monitor all its licensee's products.

7.3 Environmental risk

According to Noordewier et al. (1990, p. 83) "Environmental uncertainty is defined as unanticipated changes in circumstances surrounding an exchange". Furthermore, environmental risk is subdivided between technological, behavioral and market risk (Yang et al., 2012). It depends on the degree of these risks, which institutional form minimizes transaction costs (Yang et al., 2012). In this section I will try to find environmental conditions that call for the institutional form of licensing to minimize transaction costs.

One such environmental condition is when there is a rapid succession of technologies. This would be categorized as high technological risk. This leads to a risk of investing in technologies that might become obsolete before the investments in them have paid off. A company can try to mitigate this risk by choosing to license their inventions instead of developing products. By doing so, they can bring the technology to the market earlier than when they would need time to produce products with them. Another advantage is that by licensing out the technology, the innovating company can enlarge the footprint of this technology in the market. Consequently, increasing the chances of becoming the dominant technology (Arora and Fosfuri, 2003).

Contrastingly, when behavioral risk is high, licensing is not the preferred institutional form. As mentioned before, it is generally difficult for a licensor to measure the compliance of the licensee with agreements. Therefore when a licensee has a tendency to display non-complying behavior, licensing increases transaction costs.

Market risk is conceptualized by Yang et al. (2012) as the chance that the purchased item does not satisfy the needs of the buyer. Thus when it is hard to read a market, and thus to determine what the needs of the customers in that market are, there is a high market risk. Licensing can somewhat lower the market risk, because the underlying patent of the license is deployable in multiple end products. Therefore the needs can be less narrowly defined.

8. Governance mechanisms applied to licensing

In order to keep transaction costs as low as possible, the governance mechanisms should be adapted to the transaction attributes and the institutional form. Consequently the degree of contractual terms as well as the degree of relational adaptation mechanisms should be optimized.

8.1 Contractual terms

As mentioned before, contractual governance mechanisms entail the use of contracts to safeguard opportunistic behavior (Yang et al., 2012). Because performance ambiguity for licensing is generally high, contractual governance mechanisms play an important role to protect the licensor from opportunistic behavior from the licensee. These contracts should be as specific as possible and should take into account all future contingencies known ex ante the transaction. This then could minimize the opportunistic behavior of the licensee. This then results in lower transaction costs.

8.2 Relational adaptation

Licensing transactions are more complex than goods transactions in the sense that

with licensing, knowledge is transferred. This knowledge is derived from the licensors innovation. To be able to transfer this knowledge it should be codified (Teece, 1988). For example in descriptions, designs, blueprints or other means. These codified artifacts differ in their degree of accuracy. Adding to that, not all of the knowledge of an innovation can be codified. This knowledge remains in the heads of the innovators themselves. These factors combined hamper the successful transfer. This could result in the licensee's perceived non-performance by the licensor. This leads to increased licensee transaction costs due to the non-realization of expected rents from the innovation. In turn, this dissatisfaction of the licensee reduces return business for the licensor. To counter these effects, relational adaptation mechanisms should be in place. When the licensee is experiencing problems implementing the knowledge, due to inaccurate or incomplete codification, the licensor should offer to jointly solve these problems. This can be done by actively sharing information over time and involving the employees that themselves were active in the innovation process.

9. When should licensing be applied

Taking these findings into consideration, it is interesting to look at circumstances in which it is beneficial for a company to choose to license. Due to the high performance ambiguity, licensing should best be applied in countries where there are institutions that safeguard intellectual property rights and legal measures are available to enforce licensing agreements. However, licensing could especially be an interesting choice in upcoming markets where there is ample amount of cheap

labor and production forces, but a lack of knowledge. These countries, however, could lack the institutional infrastructure needed to safeguard intellectual property rights. Especially the BRIC countries are interesting for the aforementioned reason to license in, but none of these countries has fully developed intellectual property rights or enforcement mechanisms (Bird, 2006). Therefore, a company considering to license in such a country should ask itself whether its knowledge would be easily attained and applied by its licensee, rendering the licensor useless. If this is not the case, then licensing could prove to be a durable choice. A second question a company should ask itself is whether its competitive advantage lies in the knowledge they possess. Because when there are other companies that are better at innovating, it makes no sense for a company to try to compete on the basis of knowledge. If, however their competitive advantage lies in their knowledge, they should ask themselves whether they have the ability to transfer this knowledge into a license. Being able to innovate is one thing, but to successfully transfer this knowledge is a different capability. Especially since knowledge is an intangible resource that needs to be codified before it can be transferred. It is thus a combination of the environment and the capabilities of the firm that determine whether licensing is a viable choice.

10. Conclusion

This paper discusses the relationship between licensing and transaction costs. Licensing makes use of intellectual property rights to transfer knowledge gained from innovations to a licensee in return for a monetary fee. These property rights are

essential in that they protect the innovator against copiers. It also provides a means to define what it is that they are licensing. Transaction costs are the costs incurred in coordinating and connecting all the parts in the production chain (Den Butter, 2012). This paper uses the transaction cost framework developed by Yang et al. (2012) when trying to connect transaction costs to licensing. This framework states that transaction attributes, institutional form and governance structures should be aligned to minimize transaction costs. While applying this framework, it is argued that licensing can increase asset specificity because of the extra incurred costs of defining rules for use for the licensed innovation. On the other hand it could also decrease asset specificity, because of the decreased need of estimating customers' demand. Therefore, performance ambiguity for licensing is relatively high. This is due to increased difficulty of measuring compliance by the licensee and the extra effort the licensor has to make to convey the value of the innovation. Furthermore, licensing can offset some of the higher transaction costs involved with high technological risk and high market risk. And that when behavioral risk is high, that licensing increases transaction costs. Moreover, it seems that contractual governance mechanisms are of increased importance, because of the higher performance ambiguity related with licensing. And that relational adaptation is important as well to keep transaction costs, involved with licensing, low as well. It is argued that the question whether a company should license is determined both by the environment as well as the capabilities of the company.

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TCE and foreign entry mode of service firms:

a case study in the international relocation sector

Remo Corstjens

Introduction

Companies from small domestic markets often seek to expand their revenue by internationalizing (Johanson and Wiedersheim, 1975). Companies begin to internationalize when they are still comparatively small and gradually increase their development abroad. Companies choose to either expand to other small foreign markets or they choose to internationalize into relatively large foreign markets. A firm's decision to go abroad is concerned not only about what markets to enter but also about how to enter them (Lee and Lieberman, 2010). A firm's choice of the mode of entry into a foreign market is one of the most important strategic decisions made by companies (Shane, 1994). It is difficult to change to another entry mode, when one has already invested a lot and has to abide to certain long-term contracts.

The amount of control the firm will have over its foreign business activities will be determined by the choice of entry mode (Erramilli and Rao, 1993). An entry mode can be defined as "a structural agreement that allows a firm to implement its product market strategy in a host country either by carrying out only the marketing operations (i.e., via export modes), or both production and marketing operations there by itself or in partnership with others (contractual modes, joint ventures, wholly owned operations)" (Sharma and Erramilli, 2004).

There has been a lot of research to the entry mode choices and internationalization of firms. The dominant theory in foreign market entry choice is the Transaction Cost Economics framework (TCE) (Taylor et al., 1988). The TCE perspective views the entry mode choice as a critical decision of

governance. Resting on the interplay of two key assumptions of bounded rationality and opportunism and the three key dimensions of transaction (i.e., asset specificity, uncertainty, and frequency), TCE advocates a governance form that can minimize the costs associated with governing and monitoring transactions (Williamson, 1979, 1981, 1987, 1999).

Although, there has been a considerable amount of research on the topic of foreign market entry and transaction cost, this paper differs in the following way from previous research. Whereas previous research was predominately focused on manufacturing firms, this paper focuses on service firms. Furthermore, in contrast to previous research, this paper discusses a case study of an international company and aims to provide insights relevant to the practical application of TCE in strategic management. The research question is how companies use the TCE framework when deciding on the mode of entry choice. The evidence of this paper stems from an in depth interview with a multinational in the relocation industry. Particular interest is given to the question whether TCE can explain the choice of entry made by this service company.

The rest of the paper is structured as follows: Section 2 describes the Transaction Cost Economics framework, with specific attention on service firms. Section 3 introduces the company of the case study. Moreover this section explains the relevance of transaction cost for this firm. Section 4 gives an overview of how the company manages its transaction cost in the international business environment. Section 5 concludes with our main findings.

Transaction Cost Economics (TCE)

The Transaction cost approach to the study of economic organization regards the transaction as the basic unit of analysis and holds that an understanding of transaction cost economizing is central to the study of organizations (Commons 1931). Transaction cost economics were used by Coase (1937) to explain when it is better to use the market or the internal hierarchy. Oliver Williamson (1979) further developed this framework and proposed several determinants of transactions cost.

The Determinants of transaction cost

Two of the main sources of transaction cost are *bounded rationality* and *opportunistic behaviour*. Both are two behavioural assumptions made in TCE that differ from the neoclassical microeconomics. Firstly, TCE assumes that human individuals are subject to bounded rationality. Individuals with bounded rationality experience limits in formulating and solving complex problem, as well with the processing of information (Simon, 1978). Because individuals are subject to bounded rationality, it is impossible to specify complete contracts in all relevant aspects.

Secondly, TCE assumes that the risk of opportunism is present in many transactions. Opportunism defined by Williamson (1995) as "self interest seeking with guile". If individuals would not behave opportunistic, that is they would not show self-interest seeking behaviour, it would be no problem to have incomplete contracts. However, because individuals can show opportunistic behaviour, incomplete contracts can be a source of risk and cost. Without opportunism it would not be necessary to set up contracts for a transaction, a promise by the other party

would suffice. Without opportunism, the economic rationale for coordinating an exchange within a hierarchy would be substantially reduced (Hill, 1990).

The third major source of transaction cost Riordan and Williamson (1985) distinguish is *asset specificity*, which depends on the characteristics of the good or service. Asset specificity has to do with how specialized the investment made for this transaction is. Specific assets are investments made that have little value outside the specific transactional relationship (Rindfleisch and Heide, 1997; Williamson, 1991). There are three kinds of asset specificity: Site specificity, physical specificity and human assets specificity. These factors are all important, because the investments lock the supplier as well as the buyer in a bilateral exchange relation for a considerable period thereafter. The buyer and seller cannot turn to alternative sources because of the specificity of the investments, it will be more expensive from an unspecialized supplier.

The last two sources of transaction cost, which result from the characteristics of the transactions are: *frequency and uncertainty*. The more frequent a company has transactions in a market, the higher the transaction cost of renegotiating a contract will be (Klein et al., 1990, p. 197). The uncertainty of the transaction can play a role in the opportunistic behaviour of the transaction partners.

TCE and entry mode choice

Firms will attempt to minimize the combined cost of entering contractual arrangement and running and monitoring the system (Buckley and Casson, 1976). According to TCE, firms will choose their government

structure such that the transaction cost will be the lowest in the chosen structure. If transaction costs are low, a rational firm will prefer its transactions to be governed by the market. However, if the costs of adaptation, performance monitoring, and safe-guarding against opportunistic behaviour are too high, the firm will prefer an internal governance structure such as a wholly owned subsidiary or a dominant joint venture (Hill and Kim, 1988; Madhok, 1997).

Market attractiveness

There have been many authors that have researched the relation between TCE and entry mode choice. According to Taylor et al. (1988) market attractiveness is one of the most important factors. Depending on the market attractiveness, firms will choose a low control entry mode when the market attractiveness is low and a high control mode when the market attractiveness is high. When the market is already fairly saturated, market prices are, most of the time, very competitive. It is therefore probably better to choose the market over the internal hierarchy. In a market with many competing firms, profitability is often low and therefore does not justify large resource commitment and investments that are needed by high control modes (Kim and Hwang, 1992). In a perfectly competitive market, market specialists will perform efficiently, and thus keep transaction costs low. By allowing specialists to perform some of its functions, the firm can avoid some of the disabling forces associated with building intra-firm bureaucracies. Therefore, the firm is better off using a market governance structure for its transactions (Zhao et al., 2004).

TCE suggests that when the chance of free riding is high, it is more efficient to choose a high control entry mode (Anderson and Gatignon, 1986). When the uncertainty of demand is large in the foreign market, firms prefer a high control (Williamson, 1975). High external uncertainty makes it very expensive to write and enforce contracts that specify uncertainty (Taylor et al., 1988). Erramilli and Rao (1993) found that that cultural similarity of the home country and the host country lead to lower transaction cost. There is a negative relation between the cultural similarity of the home country and the host country and a firm's choice of high control entry mode. Cultural dissimilarity leads to increased information asymmetry and consequently to high monitor cost for the home country (Padmanabhan and Cho, 1996). Working with a different corporate culture of a foreign partner will lead to an increased complexity (Brouthers and Hennart, 2007). Wholly owned subsidiary could be used to avoid this complexity (Morschett et al., 2010).

Another important factor in deciding between entry modes is the foreign countries openness to foreign investment. There is a positive relation between the openness to foreign investments and the choice for high control entry modes (Contractor and Kundu, 1998).

Service firms vs. manufacturing firms

All of the factors described above have been extensively tested in the TCE literature. However, this was tested predominately with non-service firms. There has not been much research to the application of TCE in service firms. The few studies that have been conducted on service firms seem to conflict (Morschett et al., 2010).

The following paragraph reviews the findings of the few studies that did focus on service firms.

Service Firms

The most important differences when compared with production firms, is that service firms produce something intangible. Production and consumption happen at the same time. Therefore it is reasonable to assume that firms prefer to use high control entry modes when entering foreign markets. This way, firms have more control over the quality of the service. If manufacturing firms use a foreign partner firm in entering a foreign market, they can more easily control the quality of the products their partner firms is going to sell, because production and consumption are not simultaneous with manufacturing firms. Furthermore because of the heterogeneous character of services, using a partner firm can lead to more volatility in the quality of the service then when a firms uses more high control entry modes when entering foreign markets.

Asset specificity and service firms

Research suggests that service firms vary with respect to the asset specificity of their service; these variations may result in differences in mode selection (Contractor and Kundu, 1998; Erramilli and Rao, 1993; Fladmoe-Lindquist and Jacque, 1995; Murray and Kotabe, 1999). Service firms have high asset specificity, in particular high human asset specificity. Service Firms invest a lot in the training and knowledge of employees (Brouthers, 2003). Service firms prefer WHOS, because of their high asset specificity.

Environmental uncertainty and service firms

Services have the characteristics that they are produced and consumed at the same time. The firm needs to be present at the moment the service is consumed. Services are therefore people intense. These attributes suggest that service firms require greater control in order to deal with changes in the environment (Bowen and Jones, 1986; Habib and Victor, 1991). When there are changes in the environment, contractual agreements (such as joint venture agreements) may need to be renegotiated and changed (Williamson, 1991). This requires time that the service firm may not have, and reduces flexibility needed to address environmental uncertainties in a timely fashion (Erramilli and Rao, 1993). This literature thus suggests that service firms will choose high control entry mode such as WHOS, when faced with environmental uncertainty. However, other studies have found mixed results with respect to this claim (Fladmoe-Lindquist and Jacque, 1995).

Behavioural uncertainty and services

Behavioural uncertainty about the behaviour of partners in foreign markets, because of opportunism and bounded rationality, may result in high control and monitor cost of partner firms (Hill, 1990). TCE theory suggests that if behavioural uncertainty increases, firms will choose high control entry modes such as WHOS (Chiles and McMackin, 1996). In an internal structure firms can control the behaviour of their employees more efficiently (Fladmoe-Lindquist and Jacque, 1995). Because services are people intensive, culture may have a larger influence on service firms then on manufacturing firms. It is not clear in the literature, whether culture increases the

need for high control entry modes or for low control entry modes.

Case study of Corstjens Relocation Group

In order to analyse the use of TCE on a practical level, this study investigates how an entrepreneur uses the TCE framework in his/her strategic decision-making at a micro level. This type of data collecting arguably provides the most interesting and practical research directions for future research. Moreover, this case study gives an insight in the entry mode decisions of service firms, an area of TCE entry mode decision theory that is not yet well researched (Morschett et al., 2010).

The following three firm structures are investigated in order from low to high control entry mode: strategic alliance, franchise, wholly owned subsidiary. It is assumed that low control entry modes will be the standard entry mode. However, we assume that if the transaction costs may influence a company to choose a more high control entry mode such as a franchise or a wholly owned subsidiary or choose to use the market.

For this case study the company Corstjens Relocations Group in Amsterdam has been analysed. The company was founded in 1946. It is one of the largest Relocation companies in Eastern Europe. Its activities include the relocation of people to a different country (collecting, transporting and delivering the household goods to their new destination). But also complementary activities as house and school search, legal documents acquirement, and custom services. The company has a global workforce of 320 employees of which 30 employees work at

the headquarters in Amsterdam, whereas the rest of the work force works at various destinations in Europa and Asia. The clientele consist largely of multinationals, governmental and non-governmental organisations.

The company started to internationalize in the 1985. The first foreign office was in Belgrade. The main clients in this location were embassy employees. In the next years Corstjens got the contracts with the American embassy for various destinations in Eastern Europe. Soon after Corstjens got the contract for the embassy of the United Kingdom for all UK embassies in Easter Europe. After the perestroika multinationals started to locate in Eastern Europe and Corstjens begin to work for multinational firms. Internationalization is a necessary aspect in the relocation industry. The Dutch domestic market is very small for relocation companies, people generally change places within the Netherlands. They move to places not too far from their original location. Often people do not use professional firms to facilitate the relocation, but instead relocate themselves. In order to increase their revenue and profits, companies will need to internationalize. Consider this when a relocation firm has an office in Amsterdam and is now going to open a location in Brussels. One has not only the ability to relocate clients from the Netherlands to Belgium and vice versa, but one will also get orders from companies in other countries (who have no office in Belgium) to perform the Belgium part of their relocation. Expanding your operational network to foreign countries can thus be very rewarding in terms of revenue and profits. However, it is not necessary for companies to be physically present in foreign countries.

As mentioned earlier, there are also foreign firms that are not present in the domestic market of the other firm. The domestic firm can perform the part of the relocation in their home country and the foreign firm will take over the relocation in their domestic market.

Corstjens thus has several options for conducting business in other countries. It can choose to use the market in the foreign country when they have to do a relocation, but they can also choose to go for a more high control entry mode such as franchising and establishing their own location in the foreign market (WHOS). The motive for internationalization is thus to increase the operational network and thereby also the revenue and profits. Increasing the international operational network lead to lower "hard" transaction cost such as transport cost. Furthermore, in the current time and age, multinationals usually write one tender offer for multiple destinations. Relocation firms will only have a chance to win this contract if they are present in all the destinations by WHOS, joint ventures or franchise. It is also possible to win the contract if the company makes use of a strategic alliance in some of the destinations. However, multinationals have a strong preference for firms with own locations in all the destinations specified in the contract. Because in this way multinationals have to deal with only one relocation company for all of their destinations. This is a reduction in transaction costs for the multinationals. Having your own locations in foreign markets can result in the acquiring of very large global contracts.

Data collection

For this paper, the goal is to analyse the role of transaction costs on a micro perspective in order to find out what the practical relevance of transaction cost on strategic management is. In particular, companies often face on a daily basis the make or buy decision. To research this it is important to have access to the executive level, i.e. the level where the make or buy decisions are made. Furthermore it is important to have profound knowledge of the industry in order to ask the most relevant questions. The company I chose to analyse in this paper is Corstjens Relocation Group. This is a family company founded by my grandfather. I have worked extensively in this company at the Headquarters and the Russian Branch. By working I was witness of the many decisions that have to be made with regards to the make or buy decision. This is not a one-time decision, rather it is a decision that is made on a continuous basis. The interview for this paper is conducted with the CEO and the COO of the company.

The interview process was structured as follows. Firstly, the questions were asked, why Corstjens wants to internationalize. Thereafter, a list was made of the countries where the company conducted most of its transactions. This list consists of 36 countries. We then proceeded by sorting the countries in categories of entry mode. This led to the scheme in Table 1. The remaining part of the interview was spent on the explanation of the scheme. The questions asked during the interview were about the following topics:

Table 1
Entry mode of Corstjens in various countries

Market	Strategic Alliance	Franchise	Wholly owned subsidiary
Brazil	USA	Bulgaria	Russia
Argentina	United Kingdom	Serbia	Ukraine
Spain	France	Slovakia	Latvia
Portugal	Switzerland	Slovenia	Poland
Sweden	Korea	Bosnia-Herzegovina	Czech Republic
Finland	China	Estonia	Hungary
Denmark	India	Lithuania	Romania
Italy	Japan	Belarus	Croatia
Germany	Singapore/Dubai	Sakhalin's Islands	

1. Reason for internationalization
2. Explanation of choice for specific entry mode
3. Benefits achieved in the current entry mode choice
4. What frictions exist in the current entry mode choices
5. What factors could lead to a change in this scheme

The interview led to some interesting findings. First of all, the relevance of industry specific factor with regards to the make or buy decisions became immediately clear. In contrast to the current literature on transaction cost, where researchers are predominately concerned with the one on one relations of certain transaction cost factors and their influence on the make or buy decisions. Researchers often do not consider industry specific characteristics. Moreover even the distinction between manufacturing and service is not considered in most studies. In the next section I will explain the importance of the industry specific factors on the make or buy decision.

Managing transaction cost

As is noted in the literature internationalization can result in an increase of the revenue and profits of a firm. The entry mode literature is very extensive. There is however a considerable amount of studies that conflict each other. Furthermore, most of the studies conducted on this subject, only researched manufacturing companies. The interview provides some interesting findings. The most relevant information is described in the next subsection.

Operational network

Corstjens strongly prefers to use foreign market entries such as Franchises and WHOS. A large reduction in transaction cost comes from increasing their operational network. The more physical locations Corstjens has in Eastern Europe, the lower the transport cost will be. Moreover, the revenue increases much more when using a WHOS or franchise as entry mode versus a Strategic alliance of Market transaction, because of the increase in additional destinations of the network.

Consider the following examples.

Standard situation 1

No Internationalization.
In this situation the company is only active on the domestic market and does not deal with international transactions.

The Netherlands

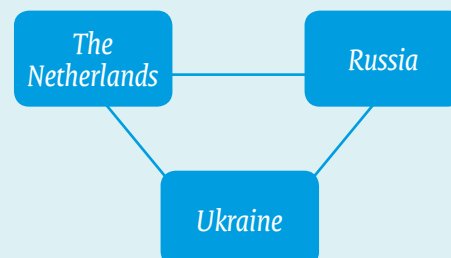
Situation 2

With internationalization via market of strategic alliance.
In this situation the company internationalizes via market or strategic alliances. By doing this Corstjens will perform relocations from Netherlands to foreign destinations and vice versa. The way this works in practice when someone is moving from the Netherlands to the USA, is that Corstjens will perform the part of the relocation in the Netherlands and a partner company in the USA, will do the USA part of the relocation. So the revenue of Corstjens, gained from the domestic market, will be complemented with the revenue Corstjens gains from performing the domestic part of international relocations.



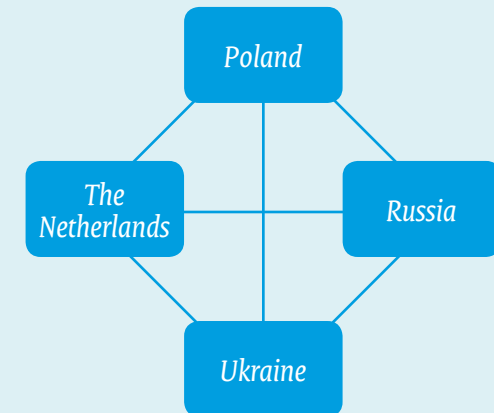
Situation 3

Internationalization via WHOS or/and Franchise.
Corstjens can also choose to internationalize via WHOS and/ or franchise. In contrast to the previous situation, Corstjens will now perform the domestic part of the relocation, as well as the foreign part of the relocation.

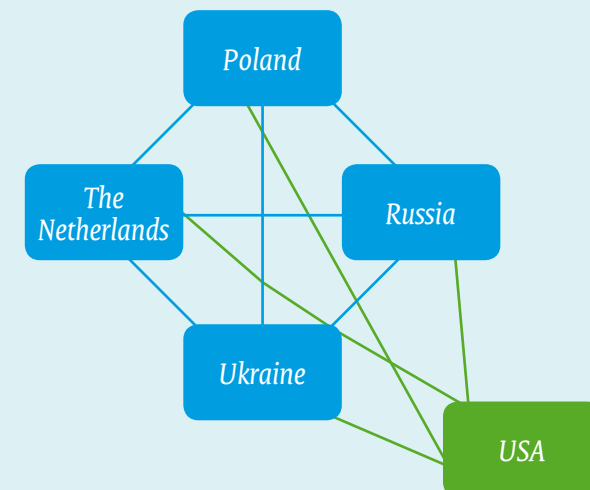


Situation 2 and 3 compared

Corstjens strongly prefers to enter via situation 3.
The reason is that, as can be seen when one compares situation 2 with situation 3, by using situation 3, Corstjens gains an additional destination, namely Ukraine- Russia and Russia-Ukraine. Entering markets via WHOS or/and franchise thus opens up other destination. Increasing your network of WHOS or Franchise adds increasingly more destinations as can be seen in the model below.



In reality, Corstjens network looks more like the scheme below.



Furthermore, a network of Franchises and WHOS are preferred by large multinationals that will only use one company to perform their relocations. Multinationals also aim to reduce their transaction costs. For multinational, using only one company is cheaper in terms of transaction costs than using a different company for each location. Therefore having a large network of own destinations can unlock large contracts from multinationals, which would be unable to be obtained when one would internationalize via strategic alliances or via the market. It became clear, during the interview, that the operational network is the most important source of reducing transaction costs for this company and quite possibly this industry.

External environment: political aspects, legal aspects

Political dynamics can play an important role for the entry mode decisions. France was one of the largest markets for Corstjens. Furthermore, Corstjens used the market for relocations. After the 2008 credit crisis, the volume in France as well as the volume from French multinationals in other parts of Europe started to decline. This was because the French government was forcing French multinationals to use domestic firms. The partners of Corstjens in France did not use Corstjens anymore even though reciprocity prescribes this. In reaction to these developments Corstjens will start a WHOS in France. Because the transaction cost will be the lowest with a WHOS as it will not suffer from the protectionism of France.

Corstjens endures very large transaction costs in Russia and Ukraine. Apart from the corruption, the accounting regulation is the largest source of transaction costs. By rule

of law it is necessary for international firms to keep, in addition to the regular English bookkeeping system, to also keep a Russian bookkeeping system. Moreover, the accounting rules of the Russian bookkeeping system differ significantly from the normal international accounting standards. The Russian system is based on a cash system, revenue is only booked when the company receives the revenue on its bank account. The creditor/ debtor system is none existent. It is very time consuming and non efficient to run this system. The accounting regulations in Russia and Ukraine are major sources of transaction cost. Therefore, the lowest transaction cost could be attained by using the market for transactions in these countries. Local companies do not have to maintain an international bookkeeping system. Hence, these local companies can perform the service cheaper, as they only have to use one bookkeeping system. However, as we will see later, every entry mode decision is made by taking in account all relevant factors.

The role of institutions:

Legal systems and industry associations

The legal system is one of the most important institutions in international trade that brings about differences in transaction costs. International trade is based on contracts. It is therefore necessary to have a good legal system present in the countries where a company is conducting its business. In the Ukraine the "legal systems is completely corrupt". A contract in this country is not worth much, because the judge will not validate your contract. This is particular true for foreign companies. The transactions cost are too high to conduct transaction via any other mode than wholly owned subsidiary. Corstjens chose to start

a wholly owned subsidiary in Ukraine because of the legal system inability to validate contracts. Even though the transaction costs are high because of the bookkeeping system, at the end, the legal factor weighted more than the bookkeeping factor in deciding the entry decision.

Another example of why institutions play a large role in transaction costs is the presence of industry associations. One of the most important institutions for the relocation sector is the Fédération Internationale des Déménageurs Internationaux (FIDI). When relocation firms satisfy a list of demanding requirements, it is possible for them to become accredited and become a member of FIDI. When a relocation firm becomes a member of the FIDI, it will benefit from several reductions in transaction cost. Firstly it will be able to use the FIDI member database. This reduces all transaction costs associated with the search and controlling of firms in markets where the company is not really familiar. The FIDI certification stands for high quality and reliable relocation firms. The transaction costs for using the market therefore are reduced. Secondly when a FIDI member goes bankrupt, the FIDI will pay all the money the bankrupting firm owed to other FIDI members back. This further reduces the search for reputable companies and control cost of Corstjens when using the market. It is important for clients to experience the same kind of quality of the relocation service in the country of departure and country of arrival. Therefore the positive influence the FIDI has on this aspect cannot be underestimated.

Market attractiveness and frequency of transaction

According to Corstjens the most important determinants of the foreign entry mode decisions are market attractiveness and frequency of transaction. It is only after analysing these characteristics of the foreign market that other determinants are considered. For example Brazil is a very attractive market with frequent transactions. So Corstjens would like to enter this market. However, its transaction costs are extremely high. There is a lot of corruption; it is not uncommon for shipments to be held in harbour customs for one month before being released after paying waiting money for every day it was held in the harbour. Furthermore transaction costs arise because of the necessity to train employees the European business culture. Lastly because of its geographical location it is costly to monitor and control. Corstjens therefore uses the market in Brazil.

Although Russia and the Ukraine are extremely risky, the attractiveness of the market and the transaction frequency ultimately determine the foreign market entry. However, other determinants may influence in what firm structure Corstjens will be present. Because the risk on opportunistic behaviour is fairly large, Corstjens will choose for a WHOS in Ukraine and Russia. Opportunism can often be present in Franchises. Corstjens used to have a franchise in Macedonia. However, the transactions costs became too large for Corstjens, because the Franchisee violated the Franchise agreements by doing a large part of the relocations on his own account. Instead of using the Corstjens network. In order to keep the lowest transaction cost. It is necessary to continue to keep analysing the transaction cost in your organization.

Transaction costs are very dynamic. Consider the examples of France and Macedonia. Markets can change very quickly; the same goes for the behaviour of franchises. WHOS definitely provide the greatest flexibility to react on these changes. So there could be a positive relation between the uncertainty on a market and the choice for WHOS. However when the most important determinants of transaction cost Market attractiveness and Transaction frequency change, it might be more appropriate too choose the leanest entry mode possible.

Culture and Foreign entry mode choice

There is no clear consensus in the literature of the influence of culture on entry mode decisions. According to Corstjens the more different both cultures are, the more probable it is to use a WHOS as entry mode. But in the interview it is again stressed that Market attractiveness and transaction frequency ultimately determine which entry mode will be chosen.

Moreover: "In a under developed markets, it is as western company easy to make a big difference". Normally it is very difficult to find a high quality company in an underdeveloped market. Multinationals in underdeveloped markets will always choose to work with foreign relocation firms. In developed markets there are already high quality companies present, which reduce the need for a WHOS. The literature on culture in Foreign entry choice might conflict each other, because other authors perhaps not always consider the significant interaction effects between culture and market attractiveness and transaction frequency.

Conclusion

This paper investigates the influence of transaction costs on the entry mode choice in foreign markets. In particular, the goal was to find an answer to the question: Can TCE explain the entry mode decision Corstjens made in entering foreign markets? The answer to this question is that TCE can explain the entry mode choices Corstjens made in entering foreign markets. However, Corstjens management does not explicitly use TCE as a theoretical framework, when it decides how to enter foreign markets. From the interview it became clear that the more formal approach of transaction cost management would certainly benefit the company in helping decide the foreign market entry choice. Moreover, the transaction cost framework could be used as a tool to monitor environmental changes and their effects on transaction cost. In this way Corstjens could react to changes in transaction cost more in advance then it currently does.

This paper differs from previous research in two ways; firstly it investigates the influence of transaction costs in service firms. Secondly, it analyses the transaction costs on a micro perspective. Therefore it could analyse the practical influence of transaction costs on strategic management. This leads to the following three findings: Firstly, the importance of industry specific factors is the most important factor in explaining foreign market entry. During the interview it became clear that for Corstjens, increasing the operational network brings about the greatest reduction in transaction cost. Therefore, it seems reasonable to assume that in each industry there is an industry specific factor that can lead to the largest reduction in transaction costs for firms in that industry. So this factor should

be given the most attention when a firm decides to enter a foreign market. The importance given to the one-on-one relations in the current literature of transaction costs seems therefore to have less practical application in real life.

Secondly, in deciding how to enter a foreign market, the weighting of relevant factors is particularly important. The interview makes it clear that the particular situation in each country is different. Where some factors might be very important in some countries, in other countries they may be not so important. Corstjens gives the most weight to the factors Market Attractiveness and Transaction Frequency. However, these two factors might be the same in two countries, but the entry mode choice could still be different. The entry mode decision is ultimately always decided by weighting all factors that lead to the entry mode with the lowest transaction costs in that particular market.

Thirdly, transaction costs need to be dynamically managed. One needs to constantly monitor whether the chosen entry mode choice still has the lowest transaction costs. If this is not the case, then one has to alter its entry mode. This will lead the firm to endure the least costs in that country. This is explained in this paper by the examples of France and Macedonia. Because of, in this case political or changes in the behaviour of partner firms, the situation in these countries changed and the chosen entry modes did not have the lowest transactions costs anymore. This led Corstjens to alter its entry mode choice.

Future research should focus on researching the specific industry factors in different industries. It is of less practical importance to keep focusing on finding one-on-one relations of transaction cost factors that explain entry mode choices. It seems that service firms have a clear preference for high control entry modes. This relation needs to be further researched. Furthermore, firms would benefit from the development of a transaction cost management framework that can provide a more formal approach to strategic management in deciding which entry mode offers the lowest transaction mode. This framework could also be used as a tool to monitor transaction costs in a dynamic way.

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5

Samenvatting in het Nederlands

Transactiemanagement tussen markt en hiërarchie

Bij de organisatie van de productie kan een onderscheid worden gemaakt tussen productie via de markt en via de hiërarchie. Transactiekosten zijn bepalend voor de keuze tussen beide vormen van organisatie. Wanneer de transactiekosten via de markt hoger zijn dan via de hiërarchie is het het beste om de productie binnen het bedrijf te organiseren. Het omgekeerde geldt voor een keuze van organisatie via de markt.

Dit gedachtegoed is ontleend aan het baanbrekende werk over het producentengedrag van Ronald Coase, Nobelprijswinnaar economie in 1991, en in 2013 op 102-jarige leeftijd overleden. Daarbij kan Coase ook als grondlegger worden beschouwd van de leer van de Nieuwe Institutionele Economie. De keuze tussen markt en hiërarchie is echter niet de enige die ondernemers kunnen maken bij de organisatie van de productie. Vele tussenvormen zijn denkbaar, zogenaamde hybride organisatievormen. Te denken valt aan coöperatieve samenwerkingsverbanden, allianties, licensering en franchising. In het kader van de honourscursus aan de Vrije Universiteit Amsterdam "The Economics of globalization: A transaction costs perspective" van prof. Frank den Butter en prof. Henri de Groot is door de studenten een aantal zeer goede papers geschreven dat raakt aan dit gedachtegoed. Deze papers zijn gepresenteerd tijdens een workshop in Den Haag waar over de papers met een aantal belangstellenden uit de wetenschap en de praktijk van gedachten is gewisseld.

Jeroen de Nie

An enquiry into the relation between licensing and transaction costs

Het paper van Jeroen de Nie beziet het verband tussen transactiekosten en licensering. Het doen gebruiken van door het ene bedrijf ontwikkelde ideeën of regels door een ander bedrijf door dit idee of de regel in licentie te geven kan als een hybride vorm van organisatie tussen markt en hiërarchie worden gezien. Het paper beschrijft hoe verschillende aspecten uit de economische theorie van de transactiekosten, zoals "asset specificity" en de onzekerheid over instituties en snelheid van technologische ontwikkeling, een invloed hebben op de strategische keuze om tot in licentie geven over te gaan. De wijze waarop de contracten van het in licentie geven zijn vormgegeven en de mate waarin deze handhaafbaar zijn, spelen een belangrijke rol bij deze hybride vorm van de organisatie van de productie.

Erik Blokland

Goodwill and transaction costs

Het paper van Erik Blokland gaat over het verband tussen goodwill en transactiekosten. Deze relatie is tweeledig. Goodwill speelt vooral een rol bij verkoop van een bedrijf, of bij de waardering van het bedrijf in het geval van fusie of overname. In dat geval behoort de goodwill tot de transactiekosten bij de transactie in geval van verkoop, fusie of overname. In de tweede plaats - en dat lijkt vanuit het perspectief van de economie van de transactiekosten minstens even relevant - kan goodwill gezien worden als de balanswaardering van de mogelijkheid van een bedrijf de productie en omzet te organiseren tegen lage transactiekosten. In die zin reflecteert de goodwill op de balans de investeringen in allerlei niet zichtbare activa ("intangible assets"), die er toe bijdragen dat het bedrijf een concurrentievoordeel heeft en efficiënt zijn omzet/winst weet te behalen. Het paper kijkt daarbij meer specifiek naar twee aspecten uit de praktijk: (i) de waardering van de goodwill bij de vier grootste Nederlandse banken, en (ii) de waardering van de merknaam bij multinationals met een sterke merknaam. Zo'n merknaam, en de daarbij behorende reputatie is een mooi voorbeeld van "onzichtbaar kapitaal" dat tot verlaging van transactiekosten leidt. Goodwill en waardering van de merknaam blijken sterk verwant maar niet identiek.

Remo Corstjens

TCE and foreign entry mode of service firms: a case study in the international relocation sector

Het paper van Remo Corstjens beschrijft hoe transactiekosten een rol spelen bij strategische beslissingen van een internationaal verhuisbedrijf over de manier waarop in het buitenland al dan niet met partners zaken wordt gedaan. Er worden vier verschillende manieren onderscheiden waarop de zaken in het buitenland geregeld worden namelijk via de markt, via een strategische alliantie, via Franchise en via een eigen dochteronderneming. De eerste en laatste organisatievormen komen overeen met de door Coase onderscheiden archetypen: de markt versus de hiërarchie. De beide andere manieren van organisatie zijn hybride vormen die tussen markt en hiërarchie in liggen. De constatering in het paper is dat het internationale verhuisbedrijf alle vier de vormen al naar gelang de omstandigheden benut en op dat punt ook een flexibele en dynamische bedrijfsvoering heeft. Veranderde omstandigheden kunnen ertoe nopen om de organisatievorm aan te passen. Het blijkt dat bij deze beslissingen de afweging van de verschillende in de theorie onderscheiden vormen van transactiekosten een belangrijke rol spelen. Maar dat is wel intuïtie: in de praktijk wordt niet met transactiekosten gerekend. Dit paper verschaft een uitstekend voorbeeld van hoe een case studie over transactiemanagement er uit kan zien. Uniek daarbij is dat het over een bedrijf in de zakelijke dienstverlening gaat en niet, zoals voorgaande cases over bedrijven uit de maakindustrie.

RITM: Research on managing transactions costs

www.feweb.vu.nl/nl/afdelingen-en-instituten/ritm/

What is RITM?

The Research Institute for Trade and Transaction Management (RITM) combines academic scientific research and commissioned research projects based on transaction costs economics. All projects have practical relevance for a transaction economy like that of the Netherlands. RITM is a research initiative of VU University Amsterdam. Transaction management, i.e. the skill to keep transaction costs low and to create value in transactions, is the focus of the research of RITM. Expanding our knowledge on how to reduce transaction costs and on how to create value in various types of trade transactions is the major aim of RITM. Part of the research of RITM is sponsored by the 'Transactieland.nl' foundation

What is transaction management?

Ever since the 17th century, known as its Golden Age, the Netherlands succeeded remarkably well in keeping its leading position in world trade. Even today a considerable part of its welfare stems from trade and good skill in managing transactions, especially in this era of globalisation where supply chains become more and more fragmented. In this context trade should be seen in a broad sense as exchange of property rights. Many people in the Netherlands earn, directly or indirectly, money by conducting and enabling such transactions. This long lasting experience as a trading nation is a major reason for the establishment of RITM.

Apart from comparative advantages in production, transaction costs are the main determinant of (international) trade flows.

Similarly, differences in transaction costs are crucial for the location and investment decisions of firms on where to produce, and on where to organize and orchestrate production in their headquarters. So knowledge on transaction costs, and on how to manage these transactions, is vital for these trade and investment decisions. Therefore, efficient transaction management which reduces transaction costs, will make existing trade more profitable and will lead to more trade. It strengthens the competitive position of individual firms, and, through spill-over effects, of the whole nation so that it enhances welfare. In this way a reduction of transaction costs creates value for firms and society. The conundrum is that with lower transaction costs total transactions will rise more than proportionally, so that transaction costs will take a larger share of total costs. It enhances the importance and profitability of transaction management. Hence, shortly stated, *transaction management is the ability to keep the costs of trade transactions as low as possible so that the value creation from these transactions is optimized.*

Globalisation and information technology bring about rapid changes in the way trade transactions take place. It creates new trade opportunities. Therefore it is necessary that one should be aware of these changes and opportunities, and know how to react and invest in knowledge on transactions. For instance, formal barriers to trade, such as transport costs and import restrictions, will gradually disappear. It makes informal trade barriers such as cultural differences, legal infrastructure, rules and regulations of local governments, red tape and especially trust between

trading partners of more importance. The more knowledge we have on these aspects, which is partly tacit knowledge, the better we can strengthen our position of managing transactions. In the world of globalisation and global (out)sourcing it is vital for companies to preserve the orchestrating function in the production, the demand and supply network. Major questions in this respect are: where and how can we buy ideas for new products and services, how do we obtain knowledge on making these products and providing these services, where do we find labour, and where and how can we continue and improve selling these products and services at the highest margin? Financing and risk management are an important part of that management function. Therefore, a major focus of the research on transaction management is to cope with cultural diversity. The ability to work together in such cultural diversity is one of the main assets of a good trader.

Institutions play a major role in management of transactions. Different institutions may bring about different types of transaction management. A major example is whether transactions take place according to formal or informal contracts. Although globalization brings about some convergence of institutions, or to formulate it more specifically, some dominance in Anglo-Saxon trade institutions, cultural, legal and social differences between the various countries and regions of the world will remain. Knowledge and feeling for these differences is of utmost importance for keeping transaction costs low in international trade relationships. The traditional position of the Netherlands as a trading nation is that of a meeting place for these different

ways of trading. Therefore openness to these differences, and the possibility to establish links between the various institutions of trading, is a major focus of this research programme. It will help to confirm the position of the Netherlands as a focal point between the Anglo-Saxon, the European continental, the Middle Eastern and the Asian ways of trading.

All in all, transaction management is not another management tool but a new approach, rooted in up to date economic theory, to enhance the efficiency of transactions

Which transaction costs?

Transaction costs are all costs made in trade transactions, either as an exchange of property rights in a market transaction, or as an exchange of responsibilities in a hierarchical situation. In other words transaction costs can be associated with the fuss and ado that occurs when purchasing or selling goods and services, when changing the location of production and splitting up the supply chain. An entrepreneur who is able to keep his transaction costs low, will be more successful to offer an attractive product to the market, as this type of costs plays a considerable role in international trade. In principle two types of transaction costs can be distinguished: the "hard" transaction costs and the "soft" transaction costs. The hard transaction costs relate to costs that are readily perceptible and quantifiable, such as transport charges, import levies and customs authorities tariffs. The soft transaction costs are much more difficult to observe and measure.

One can think of all kinds of costs of making and checking contracts, information costs, costs because of cultural differences and communication failures, tacit knowledge on legal procedures, formation of trust and reputation, network building, costs associated with risks and with rules and regulation in order to reduce risks, security requirements etc. Now that the hard costs decrease because of trade liberalisation and lowering of transport charges, the soft costs become more important. Good entrepreneurship in trade is needed to value these soft transaction costs.

RITM's the research programme

The research programme of RITM purports to study to what extent reduction of transaction costs and knowledge investments which foster reduction of transaction costs yield welfare gains. These knowledge investments may relate to the use of new technologies, cultural knowledge and networks in trade relationships. More specifically promoting the use of uniform standards can contribute considerably to a reduction transaction costs. Part of these effects may be external and imply a role for the government. Insight into these externalities may give a hint for the kind of innovation policy needed to foster the transaction sector. It should be mentioned that in a globalizing world, where the growth of world trade is structurally larger than real production growth, the transaction sector also becomes increasingly important in countries which are not specific trading nations.

A country that has better abilities to reduce transaction costs than their competitors will acquire a relatively strong position in trade. The Dutch case may indeed be explained by the trading culture of being able to trade at low transaction costs. An example of this evidence is the large share in world trade, which cannot solely be explained by natural factors such as a favourable geographical position. Adam Smith already noted that the Netherlands has been an outstanding trading nation and earns a large part of its welfare by means of trade. The amount of trade can be enhanced when a further reduction of transaction costs can be achieved. Lower transaction costs lead to more trade and hence to more welfare. Such welfare increases are obtained both by making existing trade less expensive and by expanding trade. As a matter of fact, trade and division of labour are directly related. The division of labour and specialisation, which allows the use of technological advanced equipment, are a basic source for productivity growth. Yet the division of labour and the consequent fragmentation of production has its limits. More division of labour brings about more need for co-ordination, which leads to more transaction costs. Reducing these costs and innovations which make co-ordination and transaction less expensive, foster the division of labour and enhance productivity further. These welfare gains by reducing co-ordination costs can be acquired in the production.

The research programme draws heavily on recent developments in transaction costs economics and on the analysis of trade costs. The traditional neoclassical theory typically neglects the presence of

transaction costs. This (oftentimes implicit) reliance on frictionless trade is surprising for theories in which exchange is at the heart of the matter. For instance, today's international trade flows, especially with respect to trade in services, can hardly be explained by traditional Ricardian models of international economics, which make trade flows dependent on comparative advantages in factor endowments. It is not so much comparative advantages in production factors, but more so in skills and performing tasks which determine today's trade relationships. Heterogeneity with respect to productivity in product development, management of production, supply chain management, purchase and sales, is a major source of comparative advantages, which drives trade flows. The hypothesis of the programme is that the Netherlands and similarly other trading nations have a comparative advantage in the management of transactions, as they are mainly innovative in the design and implementation of technologies which reduce transaction costs. From that perspective the programme aims to investigate the relevance of transaction costs for understanding several of the empirical phenomena that are impossible to understand without relying on such costs. The programme centres around four areas of research in which transaction costs are dominant, viz.:

- industrial organization with a focus on the determinants of the boundaries of the firm;

- international trade with a focus on the multiple dimensions of transaction costs distinguishing between transport costs, institutional costs and cultural costs of exchange;
- foreign direct investments with a focus on outsourcing and the organization of the firm in a globalizing world;
- networks with a focus on the role of social and regional networks, and on standards as institutionalized settings that facilitate exchange of goods, ideas, etc.

The programme aims to create value both for individual firms and organisations participating in the programme and for the society as a whole. The value for individual firms participating in the programme is created through the reduction in costs that will be caused by the implementation of the methodology developed in the research, and through the value creation from that implementation. This value represents the total reduction in costs at the firms. Additional value for society is created through an increase in consumer surplus that is caused by the lower price of products and services following the reduction in transaction costs.

Value for society is also created in two other ways. Firstly the programme will facilitate the development of several innovative ways of transaction management that are meant to be used publicly. This will contribute to a reduction of transaction costs between firms. This has a direct effect on the consumer prices of products and services. It will also induce more trade because the costs of trading are lower. The benefits of comparative advantages can therefore

be further exploited. These effects create societal value and improve societal welfare. Secondly the academic research on transaction management will increase attention for the further possibilities of innovation in this field. This increased attention is likely to cause an increase in the efforts to develop new methodologies and create value along these lines. The research is also expected to provide useful results and insights for companies and policy makers.

All in all this research programme seeks to acquire knowledge on how to exploit the challenges of globalisation and ICT for a further increase in the division of labour and therefore for more international welfare. Therefore, it is important to know how knowledge investments in the management and trade functions enable us to maintain in a proactive way comparative advantages in organising processes of buying, producing and selling goods and services. When doing so it is not a necessary condition that production itself takes place in the home country of (industrial) firms and companies. This is really in line of how firms in the industrialized world operate and create value. In this respect the important international role of the financial sector should be stressed. It seems that here there are still ample possibilities for innovations that reduce transaction costs. More knowledge on the dynamics of these innovations and their implications for trade, growth and welfare is required. This is a major purpose of this research programme.



